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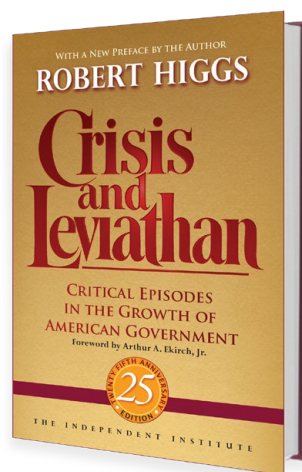
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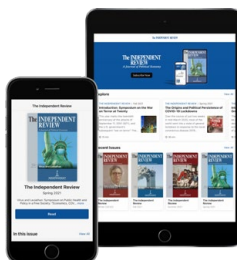
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They Stumble Who Run Fast

Roubini and Mihm's
Crisis Economics



GEORGE SELGIN

It takes only three paragraphs for Nouriel Roubini and Stephen Mihm, the authors of *Crisis Economics: A Crash Course in the Future of Finance*, to tell how Roubini stunned listeners at a September 2006 International Monetary Fund seminar by heralding a “once-in-a-lifetime” housing bust to be followed by a deep, long recession (Roubini and Mihm 2010, 1–2). Yet they may still deserve credit for modesty, for if one devoted Roubini watcher is to be believed, “Dr. Doom” actually predicted no fewer than “48 of the last 4 recessions” (comment on Elfenbein 2009).

Some quick fact-checking lends credence to our informant’s otherwise incredible claim by showing that Roubini predicted a serious crash for 2004, then a severe slowdown for 2005, then a global reckoning for 2006, and finally a sharp recession for 2007. After the much-trumpeted crisis at last materialized (though not quite for the reasons Roubini had harped on), he declared that the S&P 500 would sink to 600, that oil would get stuck below \$40 a barrel, and that a gold “bubble” was about to do what the housing one had done. To be sure, these things have not yet come to pass, but tomorrow is another day, and to succeed prophets need only mark when they hit and never mark when they miss.

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If Roubini's marksmanship impresses you, you are perhaps bound to hang on every word of *Crisis Economics*, no matter what any less-than-divine reviewer says about it. If, on the other hand, that marksmanship puts you in mind of the accuracy of a stopped clock, you may hearken to the warning that although the book's assessment of the causes of the recent great housing boom and bust is for the most part sound and informative, some of its claims are highly misleading, if not simply false.

Roubini and Mihm start well enough by dismissing as red herrings various popular diagnoses of the crisis, including the "tired" argument that it was caused by "greed," with its far-fetched though implicit assumption "that the financiers of 2007 were greedier than the Gordon Gekko's of a generation ago" (pp. 31–32). They draw attention instead to changes in the structure of incentives "that channeled greed in new and dangerous directions" (p. 32). These changes included government policies aimed at increasing poorer (and riskier) persons' access to mortgages, the growing moral hazard connected with the "too big to fail" doctrine, and the Federal Reserve's post-2001 easy-money policy.

Regarding the last, Roubini and Mihm note how, in attempting to create a soft-landing from the dot.com crash, Alan Greenspan's Fed "muted the effects of one bubble's collapse by inflating an entirely new one" (p. 73). They are contemptuous, and rightly so, of Greenspan's policy of promising to rescue market participants from collapsing bubbles, while simultaneously promising to do nothing to prevent such bubbles from developing in the first place. This "Greenspan put," they observe, "created moral hazard on a grand scale, and Greenspan deserves blame for it" (p. 73). Furthermore, they recognize (as some analysts fail to do) that the Fed was only one of several central banks that contributed to what was in fact a multination housing boom (pp. 31, 126–28). Finally, they reject Ben Bernanke's attempt to blame the credit bubble on a "global savings glut," noting (among other things) that "the Fed helped to create the unsustainable boom that attracted (global) savings in the first place," in part by encouraging American homeowners to go on a home-equity-induced global spending spree (pp. 249–50).

Roubini and Mihm also offer trenchant criticisms of the Fed's response to the crisis. They note in particular how "in its rush to prop up the financial system," the Fed "rescued both illiquid and insolvent financial institutions," exposing taxpayers to risk with its "dodgy" schemes for purchasing toxic assets and helping to "sow the seeds of bigger bubbles and even more destructive crises" (pp. 136, 153–54).

However, although Roubini and Mihm draw attention to some of the many ways in which governments—especially the U.S. government—contributed to the crisis, they overlook or understate others. In particular, they seriously underestimate the part played by the Community Reinvestment Act (CRA) and the government-sponsored enterprises (GSEs). "The huge growth in the subprime market," they write, "was primarily underwritten not by Fannie Mae and Freddie Mac but by private mortgage lenders like Countrywide" (p. 76). But even though Fannie and Freddie did not *originate* any subprime loans, they bought and (implicitly) guaranteed plenty

of them, including a very large share of the CRA-eligible “Best Practice” loans that Countrywide made between 2001 and 2007 in order to satisfy a \$1 trillion commitment to the Department of Housing and Urban Development. The poor-quality mortgages that Countrywide could not fob off on the GSEs, despite bribing their CEOs with “VIP loans,” were sold, either as whole loans or bundled into securities, to other lenders that used them to meet their own CRA requirements (Pinto 2010, appendix B). In light of this fact, and granting that mortgage brokers, appraisers, banks of all kinds, rating agencies, and monoline insurers also played their parts in inflating the housing bubble, one may well doubt Roubini and Mihm’s conclusion that “the significance of government intervention was dwarfed by the significance of government inaction” (p. 61).

Their suggestions for avoiding future meltdowns also reflect a failure to properly weigh policy’s contribution to the crisis. They again start well by recognizing the need to contain moral hazard by restoring to the financial services industry “the creative destruction that Schumpeter saw as essential for capitalism’s long-term health” (p. 179). “Capitalism without bankruptcy,” they observe (quoting former Eastern Airlines president Frank Borman), “is like Christianity without hell” (p. 155). Putting the brimstone back into banking means letting bad banks fail and giving “haircuts” to their creditors. As Lehman Brothers’ failure made all too evident, subjecting large and highly leveraged financial firms to ordinary (Chapter 11) bankruptcy proceedings can be a recipe for chaos. But, Roubini and Mihm note, the chaos might be avoided by having larger financial firms adopt “living wills” (pp. 224–25) or by splitting ailing firms into “good” and “bad” parts, with all of the deposits in the former and all of the bad assets in the latter, so that the “bad” part can be left to fail (or not) without causing havoc (pp. 173–74).

So far so good. Roubini and Mihm suggest other reforms, however, that are at best otiose and at worst counterproductive, including their proposal that “too big to fail” enterprises be forcibly broken up by means of a “beefed-up” Glass-Steagall Act—“Glass-Steagall on Steroids,” they call it (p. 230). The proposal suggests incorrectly that the original Glass-Steagall Act of 1933, had it remained intact, would have gone some way toward preventing the crisis. But notwithstanding a widespread belief to the contrary, the 1999 Gramm-Leach-Bliley “repeal” of Glass-Steagall did not remove former restrictions on commercial banks’ securities dealings. It did allow commercial banks to become affiliated with investment banks, but the insolvency or near insolvency of Lehman Brothers and the other independent broker dealers during the crisis does not appear to have had anything to do with troubles encountered by their commercial-bank affiliates. The relatively small size of those affiliates also means that the large investment banks would have been no less likely to be judged too big to fail without them.

A “beefed-up” version of Glass-Steagall might, of course, spin a much tighter web of firewalls than the original did and therefore might succeed in making “too big to fail” irrelevant. But as Roubini and Mihm themselves argue, if only in passing,

adoption of their own suggestions for reforming financial-firm bankruptcy procedures would render such draconian reform otiose because many too-big-to-fail firms “wouldn’t even exist were it not for heavy helpings of government largess,” including both implicit guarantees and actual bailouts that have been slanting the financial-industry playing field in gigantic firms’ favor (p. 227). The authors’ suggestions for regulating financial firms’ executive compensation schemes (pp. 184–91) are subject to a like criticism because firms might be expected to place a higher premium on prudence than they do at present once imprudent decisions are more likely to occasion bankruptcy than bailouts. (Central-bank bureaucrats, in contrast, might have their incentives usefully realigned by deducting central-bank portfolio losses from their pay.)

Readers should also tread warily through the hackneyed history of thought concerning economic crises that makes up the second chapter of *Crisis Economics*. Here Adam Smith is portrayed as a Walras-Debreu manqué who blinked at capitalism’s “vulnerabilities” (p. 40)—as if the Ayr Bank’s collapse made no impression on him. Louis Bachelier’s theory of speculation is said to have gained a U.S. following prior to the Great Depression (p. 40), when in fact it was more or less unknown here until Paul Samuelson drew attention to it in the 1960s. Marx is credited with the “hugely important insight” that crises are “part and parcel of capitalism” (pp. 45–46), as if he had in mind occasional financial panics rather than an inevitable decline in firms’ average rate of profit. (As for the obsolete theory of value on which Marx’s theory rests, it is perhaps understandable that it should escape criticism from authors who elsewhere declare with a straight face that “[u]nlike other commodities, gold has little intrinsic value” [p. 297].) The incomprehensible (“exceedingly complex”) parts of the *General Theory* are as usual treated as proof of John Maynard Keynes’s genius rather than of his being, well, incomprehensible (p. 47). Finally and especially disappointingly, because their account of Austrian school thought confounds the Mises-Hayek theory of the business cycle with Schumpeter’s theory of creative destruction (54–58), Roubini and Mihm manage to overlook the one extant theory that best fits the housing boom–bust story.

The occasional digressions on economic history in *Crisis Economics*—especially the book’s *obiter dicta* concerning the Great Depression—must likewise be taken with a grain, if not a scoop, of salt. Thus, Herbert Hoover is said to have stood idly by while “thousands of banks” went under (p. 53), whereas in truth he struggled in vain to get the president elect to endorse plans—which could go nowhere otherwise—for emergency banking legislation, including a national bank holiday (Flynn 1961, 16–32; Fuller 2009, chaps. 13 and 14). (Much of FDR’s famous first fireside chat appears, by the way, to have been the handiwork of *Hoover’s* Treasury officials, FDR himself having until his inauguration thought of the unfolding crisis merely as useful device for blackening the Republican Party [Flynn 1961, 27; Kiewe 2007, 78–80].) The authors wrongly credit fiscal stimulus and New Deal interventions for the 1933–37 recovery (p. 161), whereas the real cause was monetary expansion based mainly on net gold inflows (Romer 1992).

Roubini and Mihm blame the secondary deflation of 1937–38 on renewed attempts to balance the budget (p. 61), but the true culprit was the Federal Reserve’s doubling of minimum bank-reserve requirements—a doubling that was, incidentally, possible only thanks to legislation that Roubini and Mihm applaud elsewhere (pp. 182–83). World War II is said to have at long last brought “sustained recovery of growth” (pp. 182–83), but the most painstakingly derived wartime gross national product numbers show it actually brought stagnation at best (Higgs 1992). Finally, deflation is said to be, with rare exceptions, incompatible with economic growth (p. 138), but a study published not long ago in the *American Economic Review* (Atkeson and Kehoe 2004) reaches just the opposite conclusion.

Although the items considered here represent but a small sample of what Roubini and Mihm’s “crash course” has to offer, I hope that the sample will suffice to give prospective enrollees a sense of both the course’s strengths and its weaknesses. Readers will find in this book a great deal that is well worth knowing about the causes of the great subprime debacle and about ways to prevent similar debacles in the future. If they are looking to pass with flying colors, however, they had better cram with caution.

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