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Book Reviews

THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT. BY ROBERT J. SHILLER. PRINCETON, N.J.: PRINCETON UNIVERSITY PRESS, 2008.

It is with great trepidation and anticipation that we review Robert Shiller's new book, *The Subprime Solution*. Trepidation as to the causes of the problem, which were expected to take a behavioral spin. Anticipation that, with gushing reviews from Austrian friendly writers such as Nassim Taleb, there would be a plethora of new insights into the current crisis. However, while the former proved to become reality, the latter was not to be. In fact, Shiller's two central theses defy all conventional Austrian wisdom concerning the causes and cures of the current financial juncture.

A CAUSE FOR CONCERN OR A CONERN FOR THE CAUSE?

Shiller maintains that the housing bubble remains the root cause of the calamity facing investors around the world today. As naïve investors flooded the market for real-estate, a bubble resulted from the alleged fact that these same people had never experienced, or knew how to deal with, speculative bubbles. As a feedback loop of irrational public enthusiasm propagated itself, it also bled into other markets, giving rise to bubbles in disparate global markets—from energy to wheat.

Heavy use is made of the Case-Shiller Home Price Index that he, in part, developed for the second edition of his previous book *Irrational Exuberance*. Updating the information for his new book, Shiller shows that although exogenous variables such as building costs, population growth and long-term interest rates have remained relatively steady, housing prices have skyrocketed into bubble territory. As no statistically

significant relationship can be found between this fact and the three variables, the cause is assumed to be endogenous—animal spirits gripping the attention and actions of the world. Likewise, the apparent downturn that commenced in 2006 is not explained by any divergences within the existing data.

Two significant pieces of data which would augment this comparison are credit growth rates and *short-term* interest rates. In fact, Shiller is adamant that monetary factors are not to be blamed here. This is a strange stance, given that he notes that the nominal federal funds rate was 1 percent for the year following mid-2003, and *negative* in real terms for the *31 month period* starting October 2002. Shiller's attention to long-term interest rates, which were largely unaffected by this period of extremely loose credit, ignores the effects wrought by the increase in ARMs around the same period. Maintaining that individuals were influenced by a bubble mentality, Shiller is left to defend this concept on the basis of feedback loops.

Using price-economic activity-price feedback loops, he hopes to show that rising prices lead to rising prices. As speculation leads to price increases, genuine economic optimism is increased accordingly. This breeds more spending, causing greater growth, which in turn causes additional optimism and hence more bidding up of the original prices. The mere fact that price increases have occurred in so many diverse areas can be explained away due to the "contagion of market psychology" that knows "no borders due to the global nature of the story that fed it." Could it be that an exogenous variable was simultaneously increased in *every single locale* on the planet coinciding with the bubble? Shiller thinks not; monetary variables can have no effect in what is essentially a psychological phenomenon.

Information cascades are used as one specific example of how individuals abandon their own independent collection and assessment of information and instead use general, group generated information to make their decisions. As a trend develops towards all individuals assuming that no other individual is significantly wrong in interpreting information, a quality degradation occurs as no incentive exists to develop *good* information. However, much like when Bikhchandani, Hirshleifer and Welch first developed the concept, little work has been done explaining what incentive individuals have for sacrificing the quality of their information. Shiller posits that this is due to the unsophistication of the average subprime mortgage buyer; however, can the same really apply to the average subprime mortgage lender? The most telling quote

of the book may be found on page 46 which states: "Most persons can be forgiven for not seeing that the sense of economic prosperity that usually attends a major speculative bubble is actually caused by the bubble itself and not by economic fundamentals." In fact, we are reminded of Hayek's (1937, p. 33) dictum that before we should ask why anyone would be wrong, we should ask why anyone would be right. Distortions in the credit-markets significantly reduced the ability of even the most sophisticated lenders to be right. The effects are now becoming apparent.

Shiller's given cause of the problem only creates an ancillary problem, akin to the chicken and the egg. By maintaining that endogenous exuberance from a bubble mentality breeds more endogenous exuberance to form a bubble, the question of which came first—the exuberance or the bubble—cannot be answered. If the bubble was caused by the perception that housing prices were unidirectional only, what gave rise to this perception in the first place? Some optimism would normally be in order after reading a passage such as: "There are certain basic economic laws that—while they may be bent over short intervals—ultimately always assert themselves in the long run" (p. 34). This runs similar to Menger's (1871, p. 51) adage that "[a]ll things are subject to the law of cause and effect. This great principle knows no exception." It is hoped that an economist of Shiller's caliber could see through the smoke and mirrors of his current assessment, to see the inexorable relations that exist between money and credit growth, moral hazard, risk taking, and speculative asset prices.

BAIL-OUT AND REGULATIONS —A *NEW* NEW DEAL

After Shiller's analysis of the causes of the sub-prime crisis, his solution comes as no surprise. He argues for a new "New Deal" and distinguishes between a short-term solution and a long-term solution. For the short-term he calls for a bail-out of investors and borrowers. In order to conduct the bailouts practically and efficiently, Shiller wants to revive a New Deal institution—a new Home Owners' Loan Corporation—that will make credit available for home borrowers. These bailouts of low income borrowers with tax payers' money are to be regarded as a "sign of humanity" (p. 173). He also makes clear that the bail-out is not about peanuts but that "[w]e must be willing to devote sufficient resources to doing the bailouts right" (p. 111). Shiller emphasizes that the very costly bailouts on the part of tax payers are only a short-term solution, yet he regards

them as necessary under the circumstances in order to restore confidence. Again, he sees the problem primarily as psychological in nature and warns of its systemic effects. He fears a loss of trust and belief in the economic system with harmful consequences for the economy and social fabric; people would suffer needlessly if no action were taken.

Consequently, we see a kind of reverse causation in his analysis. Shiller argues that the financial losses caused by the burst of the psychological bubbles are detrimental to the confidence of the economic agents. This reduction of confidence causes the rate of output to decline, i.e., real losses occur. However, the real causation is exactly the reverse. There has been a huge credit expansion resulting in severe malinvestments.[1] These malinvestments constitute real distortions in the structure of production that must be liquidated sooner or later. That means that the real problems of the economy already exist. These real problems ultimately cause the financial losses, not the other way around.

While Shiller's short term solution calls for massive government spending and a revival of the New Deal, his long term solutions increase government interventions into the economy even more. Thus, he calls for a new information infrastructure. This comprehensive program calls for the government to subsidize a comprehensive financial advice service to mortgage borrowers, establish a consumer-oriented financial watchdog, adopt default conventions for standard mortgage contracts, improve disclosure of information regarding financial securities, create large national databases of fine-grained data pertaining to individuals' personal economic situations, and create a new unit of value measurement based on inflation-indexed contracts. Several comments come to mind regarding this list.

First and foremost, these measures do not prevent future bubbles or crises, because they do not eliminate the root of the problem. The capacity of the financial system for credit expansion and to invest without prior savings leading to malinvestments which may reveal themselves as financial bubbles is not inhibited by these measures.[2]

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[1]These malinvestments form the core of the root cause of the bust in Austrian business cycle theory. For elaboration of this point, see Hayek (1931), Mises (1949), and Garrison (2001).

[2]For the relationship between the Austrian business cycle theory and asset prices see Bagus (2007, 2008).

Second, information in our current, Internet age is more available than ever. Yet, the housing bubble developed regardless of this fact. Moreover, only in retrospect does the view become common that a bubble existed. Before the current crisis the common opinion was that everything was fine.[3] Greater availability of these opinions obviously does not help. The question that begs to be asked is why a new source of information would be any better than any of the existing sources. Third, the measures reflect an unprecedented degree of paternalism and regulation. In order to protect consumers, government power and control is increased considerably. Fourth, some of Shiller's proposals might arise on a free market, for example a new value of measurement and inflation indexed mortgages. However, if people do not use inflation indexed mortgages, it just may be their preference.

Moreover, Shiller does not understand that the underwriting standards and conditions of mortgage contracts were influenced by the expansionary monetary policy. In order to disperse the additional credit, banks lowered underwriting standards and gave mortgages under conditions that people otherwise would not have gotten. In addition, the databases that are supposed to help to judge the ability to pay contain another important flaw. In a recession that follows a credit expansion, many people might become unemployed quickly leading to massive defaults. The databases, consequently, cannot prevent or predict massive defaults. All this Shiller fails to understand because he lacks the correct theory to understand why the crisis occurred in the first place.

Another of Shiller's propositions is the construction of security markets for real estate that will enable short selling. Yet, again we find this does nothing to correct the root of the problem. In the stock market, short selling is possible and this does not inhibit stock market bubbles that are financed by credit expansion. Lastly, Shiller demands new risk-management institutions such as a home equity insurance, livelihood insurance and continuous workout mortgages. The home equity insurance, according to Shiller's imagination, will insure the value of houses. In order to inhibit moral hazard, the insurance should be based on an aggregate value of houses. This, however, only shifts the risk of the change in the value of the house from the owners to the insurers. If credit expansion continues and causes a new bubble that eventually bursts, the malinvestments will have been the same; only the burden of

[3]Indeed, up until very recently this was a widely held opinion.

the readjustment will be split differently with home equity insurance. The idea of a continuous workout mortgage is to adjust the terms of a loan to the borrower's ability to pay. Connected to this idea is the livelihood insurance that insures the borrower specifically against a loss of work. These ideas remind us of the socialist motto "everyone according to his needs." The implementation of these ideas would lead to tremendous moral hazard problems as borrowers have incentives to reduce their ability to pay or even to become unemployed. Shiller aims to overcome this moral hazard by relating the mortgage payment to a sort of occupational income index. The conception is that, as an individual has limited influence on the index by becoming unemployed on purpose, moral hazard would disappear. However, in this case the insurance is of limited help to a borrower. When unemployment occurs, the occupational income index falls only slightly due to this new impact. Only when there is massive unemployment, would there be a benefit. Yet, as there is the chance of massive unemployment and the probability of being unemployed is not independent from another worker being employed, the incident is uninsurable in the free market. Moreover, this measure does not change the problem of the bubble that springs from credit expansion. It only redistributes the risk from the homeowners to the insurers and lenders.

In sum, Shiller's "solutions" testify to his lack of understanding of the causes of the subprime crises. His short term solution leads to moral hazard and only inhibits the necessary liquidation of previously created malinvestments. His long term solutions do not go to the root of the problem, but lead to massive government regulations and still more moral hazard problems. Shiller's book is probably the most widely anticipated book of the year on the housing bubble by an eminent economist. Hence, it is unfortunate that his policy recommendations are so interventionist and actually call explicitly for a second New Deal. It is probable that it will help to sway public opinion towards adopting these measures.

CONCLUSION

Shiller opens the book by comparing the crisis to that wrought by the Treaty of Versailles. In this we can find much agreement. The unintended consequences of the intentions of a relative few has brought despair to the innocent. However, unlike the Treaty, we can't help but feel this calamity was avoidable. After all, Versailles resulted partially from a strong desire to punish those blamed for heaping ruin on the

masses. As the dawn looks unready to break the current darkness anytime soon, the true ruin is likely to lie in the future. Perhaps the comparison with the punishment of the guilty under the Treaty of Versailles would best be left to the future as well.

David Howden
Philipp Bagus

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