Freefall: America, Free Markets, and the Sinking of the World Economy. STIGLITZ, JOSEPH E. New York, N.Y.: W.W. Norton & Company, 2010. Pp. 361. $27.95

After reading several accounts of the recent financial crisis – bubble, collapse and aftermath – I decided that it was time to draw some conclusions. With this in mind, a respected person to consult is Joseph Stiglitz, the author of *Freefall: America, Free Markets, and the Sinking of the World Economy.*

With the financial crisis as a background, Stiglitz criticizes the financial markets both past and present. He is critical of practices within the financial community, such as: flawed mortgage origination, the sale of credit default swaps and other high risk products, misaligned and excessive incentive payments for corporate executives and traders (for example, stock options as performance incentives for corporate executives and high dollar bonuses for traders), maintaining low levels of capital, and the use of excessive leverage. He is also critical of certain aspects of the general regulatory environment, to include: excessive deregulation, failure to regulate new derivatives and derivative trading, and the mixing of commercial banking activities and investment baking activities.

Stiglitz proposes several remedies for the problems listed above. In the area of financial practices he recommends: reinstating practical and responsible rules for mortgage origination, putting restraints on the sale of credit default swaps and other high risk products, restricting incentive payments for corporate executives and traders and requiring complete disclosure of these payments, increasing capital requirements, and limiting leverage. He would change the general regulatory environment by: increasing regulation, placing restrictions on derivative trading and requiring that trading be conducted on organized exchanges, and separating commercial banking activities from investment banking activities by enacting an updated version of the Glass-Steagall Act.

In his discussion of problems and solutions, a key element throughout is the role and importance of incentives. To create the proper outcomes, it is necessary to have the proper incentives. When we have improper incentives, we will experience undesirable outcomes.

For example, incentives were improper in the market for mortgages. Mortgage originators had an incentive to maximize mortgage origination fees by writing as many mortgages as possible without regard to quality.

The mortgages (both good and bad) could then be sold to another firm – Fannie Mae, an investment bank, etc. At this stage additional fees were earned as the mortgages were bundled into mortgage securities and sold to investors. There was an incentive at this stage to bundle as many mortgages as possible into mortgage securities. The quality of the mortgage securities was of little concern because their ownership passed to the unsuspecting investors. You can see the pattern, earn the fees and pass the product, whether good or bad, to someone else.

The incentives experienced by the larger banks pointed bank mangers in the direction of taking excessive risks in the form of risky investments, risky products, trading, and utilizing excessive leverage. A high level of leverage plus high risk trading can create an explosive combination, which can lead to large profits or large losses. High risk trading continues to be an important activity for the big investment banks. This was highlighted in the summer of 2012, by the multibillion dollar trading losses of JPMorgan Chase.

When discussing incentives, it is sometimes noted that corporate managers have interests that are not in line with the interests of the stockholders. This is referred to as the "principal-agent problem". Corporate managers may be more interested in their own compensation – salary, bonuses and stock options – than the health and strength of the corporation. For example, using stock options as a payment incentive for corporate executives gives the managers an incentive to increase the short term stock price by any means, while ignoring other considerations both short term and long term.

Stiglitz turns from a discussion of financial markets and corporate management to a more general discussion of long term problems facing the United States and the rest of the world. His list of problem areas includes the following: education, health care, energy, environmental pollution, global warming, and global imbalances in trade. Stiglitz doesn't discuss these problems in detail or propose solutions. However, the fact that he shares my concerns and the concerns of many thoughtful citizens was comforting to me.

The author turns from long term problems to the role of the economics profession. For decades, the dominant theory in economics has been perfect competition. This theory is consistent with the strong belief in free markets held by many economists. In light of this strong belief, Stiglitz cautions economists not to be promoters and defenders of the market economy but objective scientists, who know the strengths and weaknesses of the economy and can make predictions based on sound knowledge.

Real world markets are very different from perfectly competitive markets. For this reason policies guided by a belief in free markets are often flawed. One reason behind deregulation in the financial industry in the 1980s and 1990s was a belief in free markets among many economists. This deregulation was one factor leading to the financial crisis. The recent financial crisis has taught us that markets are not self regulating and not self correcting, as many economists including Alan Greenspan had thought. The challenge for economists is to be scientists and put ideology aside.

In summary, we are faced with a number of problems from the well known problems in the financial industry to global warming. If we are to have a prosperous and successful future, we must address these problems. The recent history of Washington politics reveals a struggle dominated by special interests. The political process often serves the special interests and not the general interest. In this environment, many of the problems mentioned here will not be easy to solve. Going beyond the current political environment and conducting "the business of the people" for the benefit of the people will be our greatest challenge in the years ahead. In meeting this challenge, government policy has an important role to play. Good policy can help create the proper incentives and help us achieve the outcomes we desire.

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What Caused the Financial Crisis? JEFFREY FRIEDMAN (Editor). Philadelphia, PA. University of Pennsylvania Press. 2011. Pp. ix, 360. $29.95 (paper).

Who says that noneconomists would not understand the 2008 financial crisis? Jeffrey Friedman is a political scientist writing about an important economic crisis that still affects us today. *What Caused the Financial Crisis?* is an illuminating book that delves into the technical details of the 2008 financial crisis. Chapter 1 is the most important one because Professor Friedman provides an overview. The subsequent chapters have contributions from Richard A. Posner, Vernon L. Smith, Joseph E.