

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.

FREDERICK M. JUNGMAN

Northwestern Oklahoma State University

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.

Stiglitz, and John B. Taylor and others. Unlike *Too Big to Fail* that provides a narrative account about the days leading to and after the start of the financial crisis, Friedman allows the contributors to explain why this financial crisis happened, with common themes, such as the subprime mortgages, a period of expansive monetary policy, and lax regulatory framework for financial institutions. Then, some of the deeper themes that caused the financial crisis are presented such as the credit-default swaps, the Basel Accords, and the role of the ratings agencies. In fact, this is not just an economics or finance book, but this book will be useful resource in history, law, political science, and sociology as well as others with an interest in the financial crisis.

In chapter 2, Amar Bhide examines a valuable but inherently unstable combination of deposit-taking and lending functions that for several decades were regulated by tough banking rules after the New Deal of the 1930s. In the 1970s these tough rules from the New Deal era were relaxed that allowed banks to engage in more risky financial activities; however, these bankers did not have a good understanding of these risks and implications. Consequently, this risky behavior was further reinforced by changes in securities regulation that allowed greater liquidity for the stock markets and less liquidity for the banking industry.

Steven Gjerstad and Vernon Smith (chapter 3) believed that the Crash of 2008 was promulgated by a bursting of the housing bubble of epic proportions that resulted from the longest period of expansive monetary policy ever witnessed. This “cheap money” made mortgage credit easy to obtain even for those with little net wealth. In fact, those with little net wealth could make minimal down payments for a home; as a result, when the housing market busted and housing prices plummeted, their losses exceed the equity in their home. As these losses amassed, many financial institutions became insolvent resulting in diminished financing, reduced housing demand, falling housing prices, more borrower losses, and further damage to the financial system. The latter events in the financial systems affected the stock market and the real economy.

Stiglitz postulated in chapter 4 that the main cause of the financial crisis was attributed to the banks because of the misguided incentives unrestrained by good regulation. The conservative ideology along with the lack of realism in perfect information models manifested the lax regulations and enticed these people to alter politically the regulatory process. Consequently, many banks became sloppy in assessing risk and

over leveraged. It was not just the banks that engaged in this sloppiness but mortgage brokers also became sloppy because these mortgages were securitized and sold to investors. That is, if something shall go wrong, someone will clean it up. Other players can also bear some of the blame for the financial crisis: the ratings agencies that rendered subprime securities as investment grade; the Federal Reserve, which instituted expansive monetary policy; and the Bush administration, whose Iraq war and tax cuts for the rich made low interest rates necessary.

Taylor continued in chapter 5 to examine the failures of the financial system that was hastened by government interventions and actions. Taylor postulated that the housing crisis was attributed to the expansive monetary policy. After the housing bubble ensued, the Federal Reserve misdiagnosed financial markets' uncertainty concerning the value of subprime mortgaged securities as being a problem of liquidity, and misapplied the policies to correct the problem. He also stated that unpredictable terms of the Troubled Assets Relief Program (TARP) have resulted in an increase in the uncertainty in the financial markets.

Peter J. Wallison, (chapter 6) did not believe that this financial crisis was a "crisis of capitalism" as concluded by some policy analysts. In fact, the misguided housing policies and the lax regulatory policies by the Federal government of the United States promulgated the origins of the financial crisis. The Community Reinvestment Act, the directive by HUD to Fannie Mae and Freddie Mac to increase home ownership, penalty-free refinancing of home loans, the reduction of the capital requirements for banks and other factors created conditions ripe for the subprime mortgage meltdown that resulted in the financial crisis.

In chapter 10, Wallison presents and clears up the myths concerning the credit-default swaps as the promulgator for the financial crisis. Wallison provides his rationale why credit-default swaps are not the main cause for the financial crisis. Wallison carefully illustrates how the credit-default swap works. The process of the credit-default swaps is complex financial processes, but its use has a prominent role in maintaining risks in our financial system. He clearly states that the level of risk of these credit default swaps is not different from the risk of making the underlying loan. In fact, these credit default swaps allows the risks of the investment to spread-out widely rather than being more concentrated. As a consequence, the level of risk by these credit default swaps does not add to the risk.

In chapter 7, Viral V. Acharya and Matthew Richardson examined

the question, “Why did the popping of the housing bubble bring the financial system—rather than just the housing sector of the economy—to its knees?” The authors concluded that there were two methods that allowed banks to experience this financial crisis. First, financial institutions held assets in off balance sheet entities so these assets did not have significant capital buffers against them. Second, the capital regulations allowed financial institutions to reduce the amount of capital held against assets left on their balance sheets if these assets had AAA ratings. More specifically, financial institutions repackaged these mortgages into the mortgage-backed securities either on or off the balance sheets. As a result, banks had reduced capital requirements against these loans and allowed them to make more loans. A direct consequence of the latter concentrated the risk of mortgage defaults in the banks, and they became insolvent when the housing market collapsed.

In chapter 8 Juliusz Jablecki and Mateusz Macha discuss how the Basel Accords created incentives for banks to securitize mortgages. By doing this banks could hold them at low Basel risk weight, or place them off their balance sheets to achieve a greater leverage. These forms of securitization received accolades by economists and regulators for dispersing risks to investors across the world and allowed a greater resilience in the financial markets. Because many of these securitized assets were held in off balance sheets, it created more risks for these banks and promulgated greater risks posed to the financial system.

Lawrence J. White (chapter 9) examined the role of the three major credit agencies role in the financial crisis: Moody’s, Standard & Poor’s, and Fitch. It is speculated that if these ratings were not used, the subprime mortgages would not have grown so rapidly because there was such a demand for these high-rated bonds because they were sought after by the institutional investors. The basic question asked in this chapter is, why were the agencies excessively optimistic in their ratings of subprime mortgage-backed securities? He stated that the combination of their fee structure, the complexity of the bonds being rated, insufficient historical data, sloppiness in their analytical work, and market pressures promulgated for the potential problems.

In chapter 11, Daron Acemoglu provides the assessment of this financial crisis as an embarrassment to economic theory. In recent years many economists reached the conclusion that business cycles were no longer a problem, free markets did not need regulations, and large corporate entities could monitor their own behaviors. As we have

witnessed from the financial crisis, these three items are wholly inaccurate. Acemoglu points out that capitalism requires institutions that allow for innovation and the reallocation of resources toward firms that have successfully innovated, and the latter is part of the creative destruction as used in economics. Despite these deficiencies in the financial markets leading up to the financial crisis, financial innovations play an important role in financial markets under the proper regulatory framework. Finally, political reactions to the crisis that hinders such financial innovations may do more harm than good in the long-run because short-term solutions may not be beneficial for the longer-term.

The final chapter by David Colander, Michael Goldberg, Armin Haas, Katarina Juselius, Alan Kirman, Thomas Lux, and Brigitte Sloth provides a summary of affairs in economics. Economists failed to anticipate the financial crisis, but they could have contributed to it. The main problem was the use of esoteric models that showed untested theoretical assumptions being used in the development of policies. After the crisis occurred, economists were dumbfounded because their elaborate esoteric models did not anticipate the highly volatile interactions among the various elements of economy. Economists did not anticipate that such problems by their models could cause problems and just saw exogenous shocks as the source of the problems in the financial system. The financial crisis presents an ethical and an intellectual challenge in economics and provides an opportunity for reform by developing economic models that mirror reality rather than to develop esoteric models with little ground in economic theory.

Friedman and the contributors to this book conclude that the following reasons promulgated the financial crisis:

1. SEC decisions in 1970s that produced a ratings cartel among three credit rating firms. This disabled competition and information in the financial markets.
2. Various directives to increase home ownership by the Housing and Urban Development (HUD) in the 1990s that promulgated an increase use of the subprime mortgages by Freddie Mac and Fannie Mae to achieve higher home ownership;
3. The expansive monetary policy that started in late 2001 created a long period of low interest rates and created an era of cheap money;
4. The Basel Accords enacted in the United States in the 1990s that conferred significant capital advantages of banks who securitized

- loans through Freddie Mac and Fannie Mae;
5. Many states passed laws that enabled borrowers to default with little punitive actions taken against them.

Richard Posner provided an afterword in which he challenges the arguments presented in this book. One of his policy prescriptions is to have more regulation that coincides with the view of Acemoglu that the financial sector is “unregulated.” The readers of this book may find the thoughts by Posner rather thought-provoking or perhaps not very illuminating. This book provides a deep reading into the financial crisis, but it provides a greater clarity in the understanding of the financial crisis and the real causes that the promulgated the financial crisis. What real lessons will be fully learned from these assessments of the financial crisis? Only time shall tell.

BRIAN W. SLOBODA

United States Department of Labor