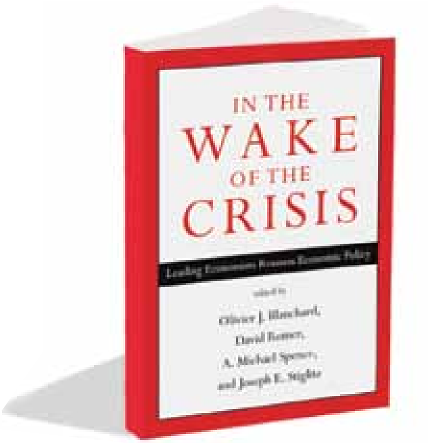
Thinking Anew



Olivier J. Blanchard, David Romer, A. Michael Spence, and Joseph E. Stiglitz (editors)

In the Wake of the Crisis

Leading Economists Reassess Economic Policy

MIT Press, Cambridge, Massachusetts, 174 pp. $19.95 (cloth).

If ever an event ought to have caused a profession to indulge in an orgy of self-doubt, it ought to have been the financial crisis of 2007–08. The world plunged into a deep recession that was not predicted by most economists, as a result of factors (inflated asset markets, excessive leverage in the financial sector) that barely feature in most economic models. Ben Bernanke, head of the U.S. Federal Reserve, in 2005 dismissed a question about a housing crash by saying, "It's a pretty unlikely possibility. We've never had a decline in house prices on a nationwide basis." In March 2007 he opined that "the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained."

After such failed predictions, a bit of humility might be in order.

The IMF held a conference in March last year to discuss the post-crisis response, and the papers have duly been gathered in a book. As IMF Chief Economist Olivier Blanchard notes in his opening piece, economists are having to think in a new way—most notably that "even with stable inflation and a stable output gap, things might not be going well behind the macroeconomic scene."

The 23 essays are not a coherent framework for a new macroeconomic policy but a series of thought-provoking pieces on monetary and fiscal policies, the financial sector, capital controls, pro-growth policies, and the structure of the international monetary system. Some pieces inevitably raise more questions than they answer, but nearly all provide important insights into the challenges ahead.

Take the idea of macroprudential policy, the "great white hope" of economic management. Future crises can be avoided (or at least their impact can be reduced) if the authorities are alert to systemic risks in the financial sector. But as Blanchard points out, macroprudential policy requires more instruments than just interest rates (changing the maximum loan-to-value ratio for mortgages, for example). A central bank would end up interfering in many different elements of the economy: would such a stance be compatible with the idea of an independent central bank, free from democratic control?

Another issue for central banks is that they have become huge players in the capital markets via their quantitative easing (QE) programs—in which central banks directly buy government and other securities to pump funds into the economy rather than cutting interest rates. Traders wait eagerly for news of further rounds of QE as a buy signal for bonds and equities. But as Nobel Prize–winning economist Joseph Stiglitz points out, that is a bit of a puzzle, since the programs have been declared temporary. "If the government's purchase of bonds leads to higher prices for stocks and bonds, its later sales should lead to a lower price." If markets anticipate the temporary nature of QE, the current price increases should be limited; if not, central banks could incur losses later on. As Stiglitz remarks, "the fact that the central bank does not use mark-to-market accounting does not make these losses any less real."

On fiscal policy, one or two Chicago economists might choke on their cornflakes at the assertion by David Romer, of the University of California, Berkeley, that "we should view the question of whether fiscal stimulus is effective as settled." A rather more nuanced view is taken by Parthasarathi Stone, who examines the circumstances in which fiscal policy is most (and least) effective; the overall level of government debt and the openness of the economy (tax cuts may simply be spent on imports) are surely factors to examine. Here, as elsewhere, the book might have benefited from input from Carmen Reinhart, now of the Peterson Institute for International Economics, or Harvard's Kenneth Rogoff, authors of a history covering eight centuries of successive economic crises.

Perhaps the other great shift in economic (and in particular, IMF) orthodoxy is a greater willingness to embrace capital controls. After all, if markets can have bubbles, they are not always efficient. And inefficient markets can destabilize economies. This is not really a new orthodoxy but a return to an old one: John Maynard Keynes thought trade flows were much more important than capital flows and devised the Bretton Woods system accordingly. China, the world's burgeoning economic power, also thinks capital flows should be subservient to broader economic goals. European politicians seem very keen to throw sand in the wheels of the markets.

So the comment by former Reserve Bank of India Deputy Governor Rakesh Mohan that "at least for emerging market economies, capital account management in its broad form should become part of the normal overall toolkit for macroeconomic management" will not provoke calls of "heresy" as it might have 10 years ago. That is a good lesson: the best way to review the crisis is to keep an open mind.

Philip Coggan
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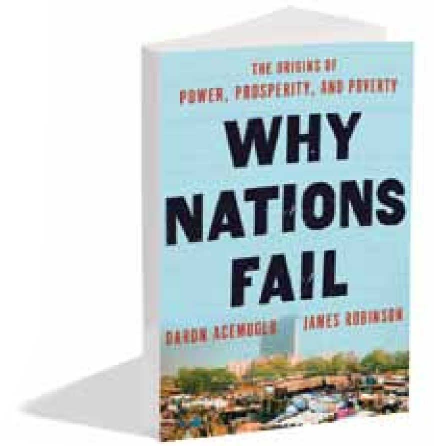
Getting to Growth



Daron Acemoglu and James A. Robinson

Why Nations Fail

The Origins of Power, Prosperity, and Poverty

Crown Publishing Group, New York, 2012, 544 pp., $30 (cloth).

This book provides a wondrous dose of healthy skepticism for anyone who thinks she knows how to get the machinery of growth and prosperity going in Malawi, Nepal, Egypt—or for that matter how to restart that machinery in Greece and Italy. Whether in your gut you follow Friedrich Hayek (a free society will prosper) or Karl Marx (an unequal system is bound to implode), or like most economists and students of development you believe in the possibility of "engineering prosperity" with good policy advice and support, this book will make you think again.

It's also a great read: ambitious and compelling in its combination of broad scope and fascinating detail. The authors argue that in the absence of inclusive political and economic institutions, nations inevitably and eventually (more on that below) fail. Without inclusive institutions to challenge and constrain the political elite (the absolutists, the monarchy, the shogun, the tribal chiefs) there is no creative destruction. The elite use political power to protect the status quo and preserve "extractive" economic rents (excessive returns from market power). The people have no reason to invest and no incentive to innovate. Economies can grow for a long time on the basis of extraction (the Roman Empire, China in the past three decades). But without the engagement and empowerment and enterprise of the majority of people, extractive regimes eventually run out of steam and succumb—to infighting and implosion or to outright defeat by outside conquerors.

The argument is illustrated by examples over many millennia (the Natufians on the Euphrates in the Neolithic Age, Mayan cities in 500 BC, England in 411), and in many places (the Transkei, the Kingdom of Kongo, New South Wales, Aksuma—now part of Ethiopia, Somalia, Japan, China, Russia). New phrases capturing key turning points enliven the story: the Venetian commend contracts, parliamentary petitioning, the Black Death, the iron law of oligarchy, the "irresistible charm of authoritarian growth."

Where do inclusive institutions come from? Why did they emerge in England (a backwater in 750 AD when the Mayan city of Copan had 28,000 people) with the Industrial Revolution, and not then or even yet in Ghana, Peru, or Russia? Why did the relatively inclusive Roman Republic yield to imperial absolutism? Why did Venice manage inclusion and then lose it? The authors don't pretend the process is simple or predictable. Nations succeed in part because they are lucky; sufficient centralization keeps chaos and instability at bay, and pluralism provides incentives for work and invention. Small differences in initial conditions combined with accidents of history ("critical junctures") lead societies in entirely different directions. The 14th century Black Death undid serfdom in western Europe but not in Russia; the rise of Atlantic trade empowered Parliament in England, but strengthened the absolutist and extractive monarchy in Spain. The Dutch East Indies monopoly destroyed indigenous inclusive institutions in Aceh, Indonesia, to enrich itself. The royal Virginia Company, its counterpart in 17th century Jamestown, Virginia, had no such luck; with land plentiful and labor scarce its workers had many options and developed their own inclusive economy and polity.

But the book is far from complete, leaving the authors room, perhaps, for a follow-on. They never define failure. What they mean is not only complete collapse (Sierra Leone, the Roman Empire, the Venetian city-state) but the failure of most nations to develop the inclusive institutions that have brought high and sustained prosperity to people in North America, western Europe, Australia, Japan—and a few other places, such as South Korea and Botswana. The story is about levels, not about managing transitions from exclusive to inclusive. And what's the relevant time frame? The "extractive" Roman Empire spanned at least 300 years of reasonably good living for a broad group of its own citizens, and the Mayan city-states even longer. Extractive politics in China has brought longer and better lives to millions of people in the past three decades, and might deliver further gains without inclusion for decades to come.

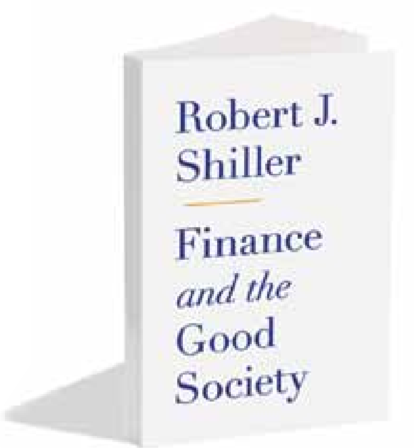
The authors argue that ultimately politics matters, not economics (or culture or geography). But they also sometimes invoke economic realities to explain political outcomes. It was the scarcity in Jamestown and the economic aftermath of the Black Death in Europe that triggered inclusive politics—not the other way round. In Peru and the Caribbean it was gold and cotton, economic endowments, that made elite extraction too easy. In postwar Korea, good economics—an inclusive economic system (the Americans imposed land reform)—eventually ushered in inclusive politics. Are not healthy global market pressures (and changing global norms about democracy, and Twitter and Facebook, and maybe even sensible advice from the IMF and the World Bank) helping that process along now in Ghana, Indonesia, and Mexico?

The authors decry the development industry's "ignorance hypothesis." They are right that the problem is not that leaders in poor countries don't know what to do—rather it is local incentives and constraints that make them unable or unwilling to follow outsiders' good advice. On the other hand, perhaps IMF "hectoring" (their term) about the ingredients of good macroeconomic policy contributed to recent steady growth in much of Africa. Perhaps access to life-saving technologies and mobile phones, the women's movement, the fight against sex trafficking, the growth of the microfinance industry, even much maligned privatization and dismantling of agricultural marketing boards—perhaps these, besides improving lives in extractive countries right now, could also, as in the Arab Spring, trigger a new generation of inclusive politics and sustained growth and prosperity in the developing world.

Or is this reviewer suppressing the healthy skepticism this book should provoke—about the influence of outsiders in an increasingly global world—and succumbing to naïve or, worse, self-interested pragmatism? If you work in the development industry—as activist, student, bureaucrat, academic, official—do read and then ask yourself that question.

Nancy Birdsall
Founding president of the Center for Global Development

Finance for All



Robert J. Shiller

Finance and the Good Society

Princeton University Press, Princeton, New Jersey, 2012, 304 pp., $24.95 (cloth).

In the wake of the crisis, I was a speaker at a seminar for senior African financial policymakers—to whom donors and international financial institutions had preached the virtue of financial capitalism. How was it, they asked, that the United States, which had been lauding the benefits of financial capitalism and privatization, was now nationalizing venerable entities such as AIG and Fannie Mae?

The collateral damage from the crisis has extended beyond sharp declines in trade and capital flows. It includes increasing hostility to the market economy itself. Robert Shiller's thoughtful analysis of the beneficial social consequences of financial capitalism then is timely.

The book draws from Shiller's rich background in finance and behavioral finance—where he has made landmark contributions—and his extensive reading in other fields, including economics, modern financial theory, behavior economics, history, psychology, sociology, and political science. This makes his analysis of finance truly interdisciplinary.

To a finance specialist, the perspectives that the author brings from the other fields contextualize many ideas that are widely and separately held by finance professionals with a silo mentality.

The digressions are fascinating—for example, the discussion on "goals and our lives" seems inspired by spirituality and Zen Buddhism—but at times he goes too far afield in discussing nonfinancial areas, and the thesis of the book—a defense of the social good of finance—is lost.

Shiller advances the need to democratize and humanize financial capitalism. His book is anchored by advances in modern finance, including financial innovation, market efficiency, financial incentives, and conflicting interests among stakeholders vis-à-vis modern corporations. Shiller argues for a broader role for finance beyond mere money making.

The author is not averse to money making, but in his analysis of the human instinct behind it, he argues that money is a means to produce positive externalities. One might invoke charitable giving, but Shiller illustrates the broader social dimension of finance that pervades our lives consciously and unconsciously. Why are the superwealthy resented? Why do we have "occupy" movements? How do the superwealthy fit into Shiller's idealized world of democratized financial capitalism?

Finance can engender excesses; it can also be an engine of growth and poverty alleviation.

Shiller's answers are, at times, provocative. The logical conclusion of Marxist thought is the self-destruction of capitalism. However, capitalism, particularly financial capitalism, has survived and even improved over the years, according to Shiller. Moreover, financial capitalism has survived modern information technology, which the author believes will leverage human capacity and accelerate the democratization of finance.

Many countervailing forces have evolved over the years to inspire a wider sense of social ownership of financial capitalism, such as employee stock ownership plans, retirement savings through wider stock and financial asset holdings, financial regulation, and corporate governance schemes to rein in the excesses of financial capitalism.

Marx did not predict such countervailing forces. Democratization of finance reduces resentment to financial capitalism. In fact, in such a setting it is not hard to imagine an environment where the superwealthy are welcome so long as they make their fortunes fairly by following the rules of the game.

Shiller also advances the idea of humanizing finance by exploiting human impulses (both positive and negative) and explores how those instincts might be used to encourage the very rich to view their wealth accumulation as a source for the greater good. So while finance can engender excesses, it can also be an engine of growth and poverty alleviation.

The book promotes a form of financial capitalism that fosters such social good. The goal is broad and the approach interdisciplinary, and Shiller is uniquely suited to provide such rich interdisciplinary analysis.

Although the book is anchored by advances in modern finance, the first part is devoted to a myriad of actors in the financial system and their roles and responsibilities. This is an excellent tutorial for those who have no substantial familiarity with finance. There are about 20 classes of actors, including CEOs, investment bankers, lawyers, traders, insurers, and even lobbyists and philanthropists.

The book is organized in a way that is useful to the understanding of specific roles and responsibilities, but I would have preferred to see it organized according to functions within the world of finance, such as savings and capital mobilization, information production, financial intermediation, risk sharing and management, and governance.

The book also advocates too much dependence on government. The author proposes a number of innovative schemes for government to implement, such as futures contracts on nonstandard products. Such proposals raise misgivings about encouraging heavy-handed government intervention.

I would also have liked to see more on the role of incentives and corporate governance in fostering finance for the social good. The size and incentive features of executive compensation have played prominently in current regulatory debates, but the book has very little to say about this. In fact, the issue of inequality of wealth and income has been attributed, in some circles, to the distorted incentives in executive pay.

These shortcomings apart, the book is eminently readable. Although the thesis is explained intuitively with very little data and complicated methodologies, the multitude of anecdotes and analogies drawn from various disciplines are powerful and encourage the reader to think laterally. Shiller should be applauded not only for advancing the democratization of financial capitalism but also for helping democratize knowledge of finance.

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