

Offices in Europe

## The Crisis and Miss Emily's Perceptions



Luc E. Leruth and Pierre J. Nicolas

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## Preface

The paper makes an analogy between the theme and the characters in Faulkner's short story "A Rose for Emily" and the current crisis. Essentially, in Faulkner's story, all the characters try to deny realities and, in doing so, allow an unstable equilibrium to last longer than it should have (hidden in her home, the respectable Miss Emily does strange things indeed, including not paying taxes).

The paper, after briefly reviewing the literature on perception biases, argues that all economic actors have, to some degree, been refusing to face realities and that has helped the crisis to unfold:

- *Academics*, because they want neat models, often at the cost of realism (the paper uses the example of the "representative agent": individual behaviors cannot always be aggregated);
- *The private sector*, because analysts relied excessively on instruments (like value-at-risk, VaR) that were not designed to remain valid in the case of a structural collapse or because some CEOs created smoke screens (Madoff);
- *The public sector*, because, as some observers (e.g., Stiglitz) have argued, there was excessive confidence in economic theory, including in monetarism and in the power of markets to solve everything, even to self-regulate (the paper also quotes a recent piece by Kay in the *Financial Times* on the fate of the Glass-Steagall Act);
- *The public at large*, because, to some extent, it benefitted from the bubble and fed it (thus, it is not only a victim, it is also an actor), while having a tendency to believe blindly the lines it is fed (e.g., by Madoff).

The paper (designed to provide some scientific evidence while remaining a pleasant read) concludes that a Faulkner of economics and finance would be most useful since, like the characters in the short story, economic actors often have visions, whereas what would be required in these difficult times is someone (like Faulkner) with a vision: not the same thing.

CHAPTER

# 1 Introduction

In one of his short stories,<sup>1</sup> William Faulkner presents an eccentric maiden lady living in a town in the south of the United States, completely withdrawn from a world that has changed, passing her by. Local residents, whose collective memory retains traces of a once rich and respectable family, keep their distance; Miss Emily, aware of her own importance (and also concerned to hide certain ghosts in the closet and certain reprehensible habits, particularly in the Deep South of the United States), keeps her own proud distance. And so, when the new local authorities of Jefferson ask her to pay her taxes—something she has never done—Emily dismisses them on the grounds of a vague verbal agreement between her family and a certain Colonel Sartoris (another local dignitary, long dead and with him any trace of the claimed agreement) that supposedly exempts Emily’s family from any requirement to pay taxes. The town worthies are impressed, accept her verdict and withdraw.

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Note: The authors are from the Offices in Europe of the International Monetary Fund in Paris (Luc E. Leruth) and ING Investment Management at The Hague (Pierre J. Nicolas). The opinions presented in this publication are those of the authors and must not be attributed to the IMF or its board of directors, nor to ING or its board of directors. The authors wish to thank André de Palma, Pierre Ewencyk, René Fiévet, Michel Lazare, Megan Leruth, and Romain Rancière for their observations. They would also like to thank Jocelyne Dyer for her excellent help in preparing the manuscript. This article appeared first in *Reflets et Perspectives de la Vie Economique*, XLIX 2010/1 (pp. 43–57) <http://www.cairn.info/revue-reflets-et-perspectives-de-la-vie-economique.htm>.

<sup>1</sup>“A Rose for Emily” (1931). The authors wish to thank Megan Leruth for suggesting this interesting reading.



In this story, an equilibrium situation, however unsustainable, is maintained only because of the nature and intensity of the perceptions the characters have of each other. Miss Emily—crazy, for sure—stands her ground with limitless bravado. Local citizens, despite several reports—some would say denunciations—seeming to indicate that something serious is going on in Emily's house (a whiff of cadaver around the house, for example), can't make up their minds to confront an aged maiden with a sterling reputation. The various pretexts cited are all futile, all coming down to a refusal to destroy a certain perception of who Miss Emily is, and along with her, the historical heritage of the town.<sup>2</sup>

In this paper, we wish to make a contribution to the debate over the usefulness of macroeconomics and finance in the debate raging since the start of the crisis, while restricting the scope of our approach to the problem of biased perceptions, which we believe have contributed to the current crisis (and helped Faulkner to write his short story at the beginning of the Great Depression of the 1930s). Consequently, our approach will be literary, and we hope the reader will find substance in the article as well as pleasure. Other readers, preferring a more quantitative approach to these questions, can consult Bénabou (2008).

Since the beginning of the crisis, debates between macroeconomists and theoreticians of finance have become ugly on all fronts (as everyone knows, macroeconomics is a profession in which each practitioner has firmly settled opinions, traditionally different from those of colleagues). As Paul de Grauwe noted in a recent article, whatever the subject under discussion may be, there will always be at least two camps, each enlisting the weight of several Nobel prize winners.<sup>3</sup> For instance, on the issue of the budget

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<sup>2</sup>"I'm sure it's nothing," says a judge, referring to neighbors' complaints about suspicious odors: "You don't bother someone like Miss Emily for no reason." "Will you accuse a lady to her face of smelling bad?" the judge asks later on.

<sup>3</sup>"Warring economists are carried along by the crowd," *Financial Times* (London, July 22, 2009, p. 9). The following day, professor Wickens of York University published a response in the FT in which he showed that Mr. de Grauwe was wrong, which tended to prove that Mr. de Grauwe was indeed right. Note that recently, some Nobel winners have assumed the role of reconciler of fellow prize winners (e.g., Phelps, 2009).

stimulus, there are those who believe that the stimulus is critical for getting out of the crisis (translation: they are Keynesians; the multiplier is greater than 1 and the risk of inflation is low), while others think that fiscal drift is irresponsible (translation: they are not Keynesians; the multiplier is less than 1 and there is a risk of inflation). And as there are doubts about the worth of the multiplier (since well before the crisis, some have argued that econometrics has not fulfilled its promises), each can claim a firm footing in perceptions, and the debate promises to be long. Others have opted for a self-flagellating approach, which will delight noneconomists (perhaps some economists as well), since the positions seem at least partially justified by the situation. Adepts of this approach are numerous and they cover a rather broad spectrum, including journalists, academics, and to be sure, economists.<sup>4</sup>

The paper is organized as follows: first we take up the subject of the perception of events in general, not just by economists (“Perceptions,” Chapter 2), before moving on in that context to the examination of certain models used by “Academics” (Chapter 3). In the following chapters, we look at the case of various private actors in the economy, that is, banks, rating agencies, and others (“The Private Sector,” Chapter 4), certain supervisors and central bankers (“Public Authorities,” Chapter 5), and finally the inhabitants of Emily’s town (“The Public at Large,” Chapter 6).

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<sup>4</sup>See Colander and others (2009) in *The Economist*, July 18, 2009; and de Callatay (2009), respectively.

For several decades now, researchers have shown an interest in studying biases that affect the perception of events by economic and other actors. Without pretending to survey the entire field of literature on the subject, we note the work of Lichtenstein and others (1978), Olson (1965), Fischhoff, Slovic, and Lichtenstein (1989), and later on, Tversky and Kahneman (1992)—all have shown that events that have a very low probability of occurring when measured objectively are perceived as having a higher probability than indicated by their objective measurement. Alternatively, an event with a very high probability of occurring will be underestimated. For instance, how many times have we heard a colleague explain repeated lateness by the fact that he or she was caught in unexpected bottlenecks during rush hour on the outskirts of Brussels?<sup>5</sup>

There are two fascinating aspects of the theory of perceptual bias (taken up by Montier, 2007, for instance) that we find particularly germane to the context of this article, both of which represent forms of “reality denial.” The

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<sup>5</sup>André de Palma provided this example during one of the many discussions we had with him on these matters. The more classic example is as follows: on average, people believe there is a higher probability of dying by being attacked by a shark than by being struck by lightning, whereas the truth of the matter is that it is 30 times more likely that lightning will carry us off (by the way, the victorious war that humans have waged against sharks has decreased these odds).

first is the “belief bias” (see Evans, Barston, and Pollard, 1983), according to which people have a tendency to judge the appropriateness of an argument depending on whether or not they agree with its conclusion. The second is “confirmation bias,” which reflects a tendency equally widespread: accept information only when it agrees with our own conclusions. The decision to go to war in Iraq underscored the importance of these effects: those who were in favor of war were generally in agreement with the argument that weapons of mass destruction were present there (while rejecting contrary arguments), while the opposite was true for persons opposed to the war (see also, Ferguson, 2004). Similarly, CFOs interviewed by the Duke University Survey were always more optimistic when it came to their own companies than they were vis-à-vis the rest of the economy (Montier, 2007), a finding that points to both denial of reality and the difficulty we have in aggregating individual behaviors into a collective behavior that matches reality (we come back to this point in Chapter 3).

Faulkner saw this clearly: denial of reality affects the judgment of everyone. There is no bad smell around Miss Emily’s house, and if there is such a smell, it is surely because a rat has died somewhere. There is no danger for the rest of the town. If needed—that is, if the odor persists—it can be covered up by spreading a little lime. Everything returns to normal and in agreement with the “priors.” We saw this in Madoff’s case as well (taken up in Chapter 4), when few institutions and investors reacted to repeated, evidence-based denunciations made over the years.

In the camp of economists, apart from Mr. Roubini (“Mr. Doom”) and a few others, the probability of the crisis was widely underestimated: actors and observers found it generally difficult to integrate information that was available to all (as also to Mr. Roubini), as well as arguments that led to disagreeable conclusions, for instance regarding the unsustainability of balance of payments disequilibrium. People were living in a world in which “pigs could fly, after all,” and dissonant notes no longer corresponded to the “priors” redefined by the majority, nor to the hopes of all. Dissonant notes were dismissed.

We don't intend to draw up a list of "denials of reality" in this crisis, nor do we want to enter into the academic details of the relative importance of "belief bias" and "confirmation bias." But we do wish to show, as in the Faulkner story, that global contamination by a virus of "reality denials" that weakened the system of rational reactions undoubtedly existed and therefore needs to be feared in the future.

Theoretical models used by academics specializing in social sciences and other sciences exhibit at least two features that are rarely found in the real world: they are simple and perfectly consistent. There is a reason that this is so. If a theoretical model in an article submitted to a professional journal is neither simple nor consistent, the referees reject it, the article is not published in a good review, and it is never heard of again. By themselves, simplicity and consistency are obviously not bad things, and they are surely preferable to complex inconsistency. To clarify our point, we certainly do not join the group who believe that academics do useless work, or who think that academics are nice dreamers lost on the outskirts of reality. Far from it. We believe in the importance of debating ideas and in the lessons to be gained from theoretical developments, especially when they are simple and consistent. This is true in social science and elsewhere. We therefore do not go as far as Paul Krugman (2009a).<sup>6</sup>

Nevertheless, it is clear that the assumptions required to make theoretical models operate smoothly are often so powerful that they restrict the field of

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<sup>6</sup>Who said recently (June 10, 2009 at the London School of Economics) that “most macroeconomics of the last 30 years (when Krugman was himself a professor [editor’s note]) was spectacularly useless at best, and positively harmful at worst.”

application of the models, and it must be said that the coefficients of macroeconomic equations are rarely stable outside fairly narrow limits. Models are hard pressed to adjust readily to structural changes, and adjustment to crises is even harder. This is well known, and has been well known for a long time.<sup>7</sup> By training, scientists protect themselves against excessively broad interpretations of their specific results by issuing a series of disclaimers. However, the temptation is sometimes great for the researcher concerned to demonstrate his or her social usefulness to the Prince (and to his subjects: economists like to distinguish themselves from other scientists by insisting on the social usefulness of their science) to begin an article cautiously and end it with recommendations on economic policy that are less cautious. The article begins by humming a tune and ends with a trumpet call. Sometimes this is done consciously, but sometimes unconsciously, for instance when the assumptions are so solidly anchored in the theoretical models that no one bothers to discuss them any more (for example, the assumption that markets are efficient). At times—and this is worse—the arguments are presented by the researchers in authoritative fashion: it is no longer a matter of establishing a thesis on the basis of a series of assumptions, but of advancing a proposal because it is in harmony with a well-established way of thinking. Krahn and Wilde (2006), for example, maintained that things were generally going well in the banking system and that systemic risk was both unlikely and should in fact be the responsibility of government (see also Colander and others, 2009). It is sometimes fortunate that the dangerous and doubtless understandable penchant that researchers have for intellectual harmony has only a limited impact on the decision makers in the private sector. Things go quite differently when these same tendencies are found in policymakers, a matter we take up in Chapter 5. Nevertheless, one does well to be wary of such a penchant, even in scientists.

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<sup>7</sup>See Colander and others (2009). The reader with a degree in economics may perhaps recall the Phillips curve linking employment and inflation: it has been wandering about for several decades in that two-dimensional space, buffeted by other economic variables. Such is the price paid by researchers bent on maintaining the notion of the “curve.”

We shall not insist here on the debates cited above, pitting various Nobel prize winners and their fans against one another. We wish instead to illustrate for interested readers the approach taken by model makers in a particular case. The pertinence of certain assumptions regarding behavior and stability, limits on the time frames during which models are tested, and the introduction of “dummies” when the data exhibit atypical behavior—these are the sorts of examples we might have chosen to use. What we have chosen is the example of the representative agent.<sup>8</sup>

The simple models taught to secondary school students are often based on Robinson Crusoe. Defoe’s picture of Crusoe is already very interesting, but economists like to add a schizophrenic dimension to him. Crusoe debates with himself concerning the amount of time he will spend fishing (Crusoe the producer) in order to satisfy the needs of his stomach (Crusoe the consumer). The character Friday is introduced early on (sometimes Thursday also appears), which helps dissociate production from consumption, while attenuating Crusoe’s schizophrenia. Even back then each block of the economy was imagined as a “representative agent,” a kind of aggregated amalgam of individual behaviors of all the agents making up the economy (e.g., a representative investor). This representative agent is subjected to a series of behavioral constraints that are very useful to make the model operate smoothly—such as perfect rationality (or almost) which enables him to anticipate, infer, and therefore make all sorts of decisions with a Spock-like cool (the hero of “Star Trek” and the idol of young U.S. intellectuals of the years 1960–1970). To exemplify, the representative economic agent anticipates future costs of government borrowing and adjusts his savings accordingly (Ricardian equivalence). The circumstances in which such an aggregation can be made without biasing the usefulness of the results are limited, yet that approach continues to be the keystone of most models. Our reservations, applied to the case of economists, could be interpreted in a

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<sup>8</sup>To readers interested in this type of debate, we recommend the July 18, 2009 issue of *The Economist*, the article by Krugman in the *New York Times* of September 6, 2009, and Colander and others (2009) already cited.



Churchillian manner: “Two one-handed economists are not the same thing as one two-handed economist.”

In any event, Miss Emily would have made a fine academic suffering from denial of reality: her life's frame of reference lies in the past, she thinks that the external world must conform to a particular case (her own), and she makes assumptions on stability that are rather unreasonable (on marriage in her case).<sup>9</sup> We could add, cynically, that she is no longer around when the extent of her mental wanderings and its cost to society (unpaid tax) are finally disclosed.

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<sup>9</sup>Continuing in a literary vein, Balzac's economic models would also have succumbed to the crisis. In *A Country Doctor*, Balzac imagines Dr. Bénassy, the village hero who introduced unfettered capitalism while at the same time caring for the poor (a kind of precursor of “compassionate conservatives”). He speaks of risks (they are few, he assures the villagers), but—fortunate coincidence—no major setbacks are visited upon the village dwellers (nor does it surprise him since, anticipating Krahn and Wilde (2006), he knows that the probability of such occurrences is low). So, Balzac has created a successful economic experiment at the scale of his narrow valley, which the doctor would like to extend to the county, then to the entire country. It is fairly probable that the coefficients of Dr. Bénassy's model are not stable at an expanded scale, but that doesn't concern him a great deal. The people he talks to are villagers stricken by idiocy and a retired soldier, both poorly trained in econometrics. They fail to question his assumptions.

The world of finance has witnessed the most flagrant abuses, and therefore we will use it to illustrate our argument. It is clear that the private sector has suffered greatly from “denial of reality,” for example with the explosive expansion of mergers and acquisitions, whose rationale was based implicitly on long-term continuation of abnormally low interest rates and on exaggeratedly optimistic assumptions about economies of scale and additional profits linked to synergies. In perhaps more spectacular fashion, we all witnessed the arrival of CEOs in Washington in private jets, to beg public money, and the televised presentations by Mr. Wagoner,<sup>10</sup> who would have made a very fitting Miss Emily if Mr. Madoff hadn’t beaten him to it by a nose.<sup>11</sup> In this section, we are going to take on two principal themes: the exaggerated confidence of various actors in validating certain mathematical models (a common point therefore between the private sector and academics, itself so rare a fact that it should be emphasized), in particular value-at-risk (VaR), which played a key role in the unfolding of the current crisis; second, we will return to the decidedly curious case of Mr. Madoff in the role of Emily.

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<sup>10</sup>To those who would like to revisit these tragic moments, we recommend, respectively, <http://www.youtube.com/watch?v=UMJ2BU0CDTO> and <http://www.youtube.com/watch?v=Zklki5WYw&feature=fvsre2>.

<sup>11</sup>Merely our opinion: Faulkner does not specify that Miss Emily—a madwoman in any event—is cynical or reckless (not to mention incompetent).

Let us start, then, with the exaggerated confidence placed in the validity of certain mathematical models, and in particular, VaR.<sup>12</sup>

The VaR of a portfolio provides a quantified value (in euros, for instance) representing its risk of maximum loss within a well-defined time frame (typically 1 day, 30 days, 60 days) and with a given confidence interval (95 percent or 99 percent). For a financial instrument, the VaR is based largely on past volatility calculated over a relatively short time frame. The VaR assumes, however, that returns will follow a normal distribution (a further example of an assumption often made but less often verified). For a portfolio, evaluation of the VaR incorporates correlations between the various component instruments, once again in the relatively short term. As Montier (2007) points out, in periods of turbulence, historic volatility and past correlations are very poor indicators of future changes in these variables. They are all the worse if the sample is limited to the most recent data, which are necessarily a reflection of the present state of affairs. More generally speaking, the principal weakness in VaR-type models is that they consider risk as an exogenous variable. But in cases of violent movements in which all the actors race to act before it is too late, and thereby pursue identical strategies, risk becomes endogenous to the system and the assumption of normal returns is no longer realized.

In the present crisis, VaR was granted unwarranted confidence and proved a paltry risk indicator, providing no danger signal at precisely the moment when it was most needed. Worse still, since most of the financial sector actors were tolerating a maximum VaR relatively independent of the context, the substantial decrease in volatility that almost always precedes a major correction<sup>13</sup> led them to take more risk. By contrast, once the correction began, the VaR had to be maintained below a certain value, despite the

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<sup>12</sup>We could have illustrated our argument as easily by using the valuation of derivatives, for example.

<sup>13</sup>This phenomenon is well known to technical analysts and was first demonstrated by Charles Dow (see Rhea, 1932). It bears the name “distribution phase” during which securities pass from “strong” hands to “weak” ones.

violent spike in volatility, which naturally set in motion a chain reaction of forced sales.

By trusting too blindly in VaR—and again, this is just one example—the financial sector showed that it was the victim of a serious illusion, namely that it was controlling the risks.

The optimistic use of models is not limited to VaRs. For instance, the rating agencies continue to attribute the same rating scale to assets of very different kinds, whether paper issued by a given business or the slicing up into tranches of portfolios composed of paper issued by a number of businesses.<sup>14</sup> By proceeding in this fashion, the rating agencies contributed to fostering still another illusion that affects investors: the illusion of secure investments. Several reasons explain this effect, including the intrinsic difficulty (rarely acknowledged and emphasized by the rating agencies) of awarding an objective rating to a bond portfolio or commercial paper issued by different companies, especially during a period of liquidity crisis, when risks of default are amplified, including by domino effects. The illusion of secure investments was also strengthened by the frequently repeated saying that the “originate and distribute” model enabled spreading risk more widely, thereby diminishing it. The idea is sound (at least from a theoretical point of view, that is, insisting on a point already made, if the initial assumptions prove to be valid), but financial institutions generalized the idea and in fact increased risks rather than diminishing them, thereby contributing to the crisis. Once it becomes difficult to determine exactly who owns what, the distribution of risk cannot be equated with its reduction. No doubt, the agencies should have reacted, but they did not. In fact, they minimized risks prior to the crisis and even during the crisis, just as most of the other players in the financial sector did. On this last point, the analogy with Miss Emily is

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<sup>14</sup>This is not the place to elaborate on the problem of conflicts of interest within these agencies, which has been commented on extensively by observers. We do note, however, that these conflicts do not stop at fostering illusions: rather, they feed the illusions by a kind of catalytic effect, each letting itself be convinced that things are better than they appear to be. In its time, the valuation of Enron’s stock spiked for similar reasons.

apposite: it is sufficient to spread a little lime and the nauseating smell will vanish; if it doesn't vanish, we look for an obvious suspect, hedge funds, for example, the root of all evils for vaguely specified reasons, in exactly the way Emily's town blamed the servant for leaving a dead rat somewhere (since no one could accept the notion that the very respectable Miss Emily might be associated with the smell).<sup>15</sup>

To conclude this section with another aspect of "denial of reality," we recall that Miss Emily makes categorical denials and does not appear surprised that her absence of argument is accepted by the town citizenry (or rather by their representatives). Was this very different in the case of Madoff? In a 2007 interview that became a hit on YouTube, Madoff describes his business in a way that seems delusional to us, now that the facts have been revealed (at least in part).<sup>16</sup> Among the most striking points, Madoff is quick to:

- Explain that mathematicians are needed in order to remove the human element from transactions, but that the mathematicians from MIT lost too much time thinking. As replacements for these professionals, Madoff preferred people like his colleague, present at the interview, and whose CV remains a puzzle despite the questions from the journalist.<sup>17</sup>
- Declare very authoritatively that it is impossible to fool the regulators (he would be very surprised if a cheater could be successful for a significant length of time).
- Underscore that the programs are precise and honest, adding with a smile that it would doubtless be possible to design programs that cheated, but that no one had done so as yet.

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<sup>15</sup>Among the reasons put forth to explain the culpability of hedge funds was the lack of supervision by the authorities (however, the banks that succumbed to the crisis were supervised) and the dubious idea that, by posting excellent performances, the hedge funds induced the banks to emulate them (under pressure from their client members) and to take on more risks than were reasonable (on this topic, see Attali, 2008 for example), especially if we assume that investors balance risk-return equilibriums rationally.

<sup>16</sup>We heartily encourage our readers to listen to, and especially observe the behavior of, the ex-diva of finance, on <http://www.youtube.com/watch?v=auSfaavHDXQ>.

<sup>17</sup>This colleague's profile is still on [www.linkedin.com](http://www.linkedin.com) (another denial of reality?) at the time of writing this article.

- Reassure investors nervous about the volatility of prices with revealing words: “trust me” and “you can take my word for it,” the star replies, he who—it has recently been revealed—didn’t even take the trouble to engage in trading with his clients’ money (*The Economist*, August 15, 2009).

Participants in the interview, very impressed to be in the presence of such a financial authority, such a “glamorous” personality with a spotless reputation, lose all their critical acumen, just like the citizens of Jefferson.

As already noted, the crisis broke out to the obvious surprise of almost everyone, including governments, and the hasty debate over the solution for dealing with the crisis quickly revealed internal tensions among executives and among governments on the international scene. We often saw running through these types of debates a thread of ideological commitment and a fervent belief in staunchly opposed models. If the crisis came as a surprise, the postmortem analyses (always easier than pre-mortem ones) by Stiglitz (2008) and others pointed a finger at the public authorities, suggesting that they also suffered from intense denial of realities that affected their judgment in numerous domains.<sup>18</sup> At this point, let us avoid returning to the question of moral failure (should Lehman Brothers not have been allowed to fail?), but we do note that sometimes the grand scope of the crisis cuts through the veil of illusions.<sup>19</sup> Two examples will illustrate our point: excessive faith in

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<sup>18</sup>And not just the authorities. To the question “How did we get into this mess?” Stiglitz suggested “A unique combination of ideology, special-interest pressure, populist politics, bad economics, and sheer incompetence.” We can regret that Stiglitz did not speak up earlier, especially given the number of causes he adduces—mythical stable cleaning comes to mind.

<sup>19</sup>On the topic of moral failure, we emphasize that the town of Jefferson readily accepts the notion that Miss Emily doesn’t pay her taxes. If the town’s citizens decided to follow her example, they might see public revenues collapse. Our literary expert, Megan Leruth, tells us that Faulkner’s short stories were preludes to a larger, unwritten novel, which might have contained that idea.

monetarism and an almost fanatical belief in the powers of market forces that extended to bank self-regulation.<sup>20</sup>

As one consequence of this crisis, it appears that the longstanding authoritative notion of the quasi-omnipotence of monetary policy—that simple and consistent theoretical development from the University of Chicago—is definitively damaged. Nevertheless, the experience of the “goldilocks” years, with relatively strong growth and moderate inflation (reflecting in part disinflationary pressure from globalization) had improved the credit of the theory (despite some painful experiences in Latin America, to be sure). But, as with all models, the necessary assumptions underlying monetarism would soon cease to be valid, as underscored by a variety of observers (Stiglitz, 2008, again; but also Richard Koo (2009), chief economist at Nomura Research Institute), given the structural changes that affected the major economies. The reality is that a monetary policy based on key rates proves to be relatively powerless in the event of a balance sheet recession, in which the predominant preoccupation of households as well as businesses is to reduce their level of indebtedness, thereby initiating Keynes’ “liquidity trap.” The impotence of monetary policy is notably manifest when the margin for maneuver in lowering key rates—already close to zero—is limited. When the authorities found themselves deprived of the traditional monetary policy lever, they resorted to less traditional methods, such as quantitative easing.

In that connection, it is interesting to note that, confronted by a collapse, it is difficult, at least initially, to throw off the traditional framework of reasoning,

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<sup>20</sup>We could also have mentioned macroeconomic disequilibriums (e.g., external balances) which had grown incessantly since the end of the 1980s, without stirring up the concern you would expect (although the IMF did organize a process of multilateral consultations on that topic). No doubt, people ended up thinking that the imbalances had no effect on the economy. And so a thoroughly abnormal situation ends up being considered natural. Similarly, for Miss Emily it is an assumption, and for the local elected officials a tolerable fact, that she need not pay any taxes. That takes us back to the perception bias treated at the start of this paper: observers underestimated the possibility that these imbalances would self-correct, whereas it was highly probable that they would do so, and violently.



and all the more so when that tradition has proved its worth in recent history. Some commentators even suggested moving to (nominal) negative key rates, thereby showing an attachment (passionate to be sure, but irrational) to recipes that worked in the past. This is an attitude frequently encountered, including in Faulkner's story: once again, the initial action on the part of the town worthies is to want to spread lime in order to deal with the nauseous odor. Luckily, in the present crisis, the authorities were able to resort to unconventional remedies—even if the obvious limitations of conventional remedies helped them.

Before moving on to the second example, and so as to avoid any misunderstanding, we would like to insist on one point: we believe that market mechanisms are generally preferable to other mechanisms, but we recognize exceptions to the rule. We therefore refuse the blind guide that led those people prepared to believe that markets are so efficient that they are able to self-regulate without external intervention. How indeed could the markets ensure that the very complex and largely misunderstood products that banks and their customers were holding were well managed as regards risks? And yet this trend of thinking won extremely wide acceptance during the 1980s, and its effect became quickly felt with the gradual implementation of a series of measures aimed at increased deregulation, in particular the 1999 repeal of the Glass-Steagall Act, in force since 1933 as a measure to avoid banking crises.<sup>21</sup> The fact is that the repeal of Glass-Steagall allowed banks to imagine combining more closely—and dangerously—the traditional activity of depository of savers' funds, and activities sometimes described as “gambling.” As John Kay stressed in the *Financial Times* on September 16, 2009:

Ironically at the very moment in 1999 at which the Glass-Steagall Act was finally repealed, the New Economy bubble replayed the abuses that had led to the act's passage in the first place.

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<sup>21</sup>Stiglitz goes so far as to underscore the irony that, with the appointment of Mr. Greenspan, the ultimate regulator was now someone who did not believe in regulation.

Irony or logical consequence? Whichever the case, we agree with Kay that a new Glass-Steagall would not solve the current problem, and that it would be preferable if bank deposits were backed up by secure assets—without losing sight of the fact that entrusting private rating agencies with the job of determining which assets are secure or not has proven disastrous.

## The Public at Large

The collective uproar asserting that the public is the principal victim of the seamy financial machinations of traders and corrupt CEOs (who continue to profit from the system), is virtually unanimous. As things stand, average citizens have suffered from the crisis and they and their children will have to bear the cost in terms of higher taxes needed to finance the interest charges and repayment of the debt in the wake of the fiscal stimulus. This is the price to pay in order to avoid a prolonged recession today. However, some emphasized that these victims have also benefited from the bubble, for instance by the increased value of their houses, and as their investments, however modest, rose in value with the financial markets.<sup>22</sup> The “victims” have therefore contributed to the crisis by unreasonable borrowing on the basis of overly valued real estate assets, which they engaged in with some enthusiasm at a time when everything was swimming. This borrowing served essentially to finance a level of consumption that was not sustainable (see, for example, de Callatay, 2009).

In their own defense, the citizens will adduce their good faith: they were deceived. If they consumed excessively, it was without knowing that their wealth was merely an illusion (based on unrealized capital gains) and that,

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<sup>22</sup>Note, however, that the children of these victims, who will have to pay back a large part of the debt, have benefited much less from these capital gains.

cleverly advised by incompetents, they believed these gains were permanent and destined to increase without limit.

The excuse is not new. It is still used regularly by the baby boomers, surprised to discover that the pensions they get, or will soon receive, are in fact a bomb, and no longer a time bomb. A decade ago or so, de Callatay and Leruth (1999) presented a debate on social benefits in which these issues were treated. Some things have changed in the interval (not many), but luckily the urgent need for reform in this domain is starting to strike the imagination (see the recent report by the European Commission, 2009). We note that, by allowing Miss Emily (a good example of a baby boomer) to not pay her taxes for a good number of years, the citizens of Jefferson thereby showed that they preferred that their children pay the taxes for them.

The final illusion we wish to consider in this article is the public's illusion of the omniscience of those involved in the Madoff affair already cited above. In itself the matter is astounding, since the powerful are often used as a target for criticism and less often held up as persons to be venerated. However, when Mr. Madoff explained the so-called operating methods of his company, interviewing journalists did not react: Madoff convinces effortlessly. The general public insists on believing in someone who understands complicated matters that exceed its grasp. This is apparently reassuring. It is even more than reassuring. On a recent BBC program, the son of a Madoff client who committed suicide after losing all his assets attempts to find traces of his father's money (or at least a portion of it), and we understand right away that some people perceived the fraud.<sup>23</sup> But society rejects such skeptics. For instance, the CEO of one hedge fund explains at a dinner party that she didn't invest with Madoff because she couldn't find a trace of his transactions. Thereupon, she is rebuffed severely by another dinner guest, appalled by her position: the other has invested with Madoff, a great, upright man, a benefactor of humanity, whose name she will not allow to be tarnished. So, there we are, once more, in the story of Miss Emily.

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<sup>23</sup><http://www.youtube.com/watch?v=o1nPvMcCFnU&feature=Playlist&p=00178FF5D773A11&index=51>.

## Conclusion

If we had to use just one word to characterize the period 2000–07, that word would be “illusion.” In academia, the illusion of knowledge; in the private sector, the illusion of limitless growth; in the public sector, the illusion of all-powerful markets; and finally the wealth illusion in individuals. To be sure, other factors played a role in setting the crisis in motion (as well as in the life of Miss Emily), but the illusions we list are often ignored and deserve to be pondered.

The denial of realities and perception biases arise largely from systematic and inevitable reference to the past, and from the fact that, in a consensual society, the existing stock of information is necessarily analyzed in more or less the same fashion by economic agents. To call into doubt the honorable character of Miss Emily would be to call into doubt an informational acquisition deemed incontestable, which is much more disturbing than forgetting the losses from tax receipts that will arise in the future. This is true of the pension bomb as well.

What solution is available? Unfortunately, the objective of this article was not to propose a solution, but rather to suggest analogies between economic actors and characters in a fiction, with the hope that such analogies might be useful. Truth to tell, we lack a Faulkner for economics and finance. He was a visionary. His characters had visions. This is not the same thing.

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