

# Benjamin M. Friedman & Robert M. Solow

## *Introduction*

The financial meltdown of 2007 to 2009 was surely a great spectacle. Mighty names toppled like that statue of Saddam Hussein. Lehman Brothers, with a history spanning a century-and-a-half, just disappeared. Bear Stearns and even Merrill Lynch – the same Merrill Lynch that had taught generations of small investors to be “bullish on America” – were sold off at discounts suitable for used furniture. AIG was rescued in the nick of time, but only with \$182 billion of U.S. government assistance. Trillions of dollars of investors’ wealth simply evaporated. One could think, “Oh, well, easy come, easy go.” But still, *trillions* of dollars? It was a spectacle all right, but why did it really matter to the rest of us, who count ourselves merely as citizens of the republic?

After all, the economic well-being of a society and its members depends on “real” outcomes: on the production and distribution of current output, some of it allocated to current consumption of goods and services and some to provision for future consumption through capital investment, research activity, and education (all net of depreciation, resource depletion, and environmental damage). That is what the economy delivers to us

folks. Apart from the sheer theater of it all, the main reason for caring about a financial crisis is the well-founded belief that serious disturbance of the financial system can impair the functioning of the real economy, perhaps drastically. A well-behaved financial system makes the real economy more efficient at producing well-being for its inhabitants (though it may parcel out income and wealth to specific groups among those inhabitants in ways that we and they may find objectionable, and maybe even repugnant). But a breakdown of the financial system can inflict damage on the real economy, damage that may last for years after the breakdown has been repaired. And so it has.

These connections between the real economy and the financial system can be far from simple. In this issue of *Dædalus*, essays by Edward L. Glaeser of Harvard University and Jeremy C. Stein, also of Harvard, show how an episode of overbuilding of houses, the sort of thing that might normally lead to a run-of-the-mill slowdown or minor recession, can be amplified and complexified by the (mis)behavior of financial institutions and the spread of securitization. We therefore end up with a disaster for the real economy – and for millions, or tens of millions, of its inhabitants. Instead of a recession that can be dealt with by rou-

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tine monetary and fiscal policy, we face the loss of more than eight million jobs and years of lost output, not to mention the indirect social costs of prolonged recession. It is all the more galling that much of the damage is borne by innocent bystanders, while many of the bad (or stupid or greedy) guys do fairly well.

The meaningful story is about the interaction of financial activity and the real economy. The mechanics of this connection are far from transparent. Many of the articles in this issue focus, to varying degrees, on aspects of this difficult and important matter, and on the ways in which a society can hope to benefit from a highly developed financial system while protecting itself, more or less, against the damage that its proclivity to malfunction can inflict. Essays by Luigi Zingales of the University of Chicago Booth School of Business and Peter Temin of the Massachusetts Institute of Technology aim to elucidate the intellectual apparatus that economists and students of finance have built to help them understand this complex piece of machinery.

One important lesson, driven home with great force by the breakdown itself, is the potential of an elaborate financial system like ours for *instability*, a subject which Benjamin M. Friedman of Harvard University, Robert M. Solow of the Massachusetts Institute of Technology, and Jeremy C. Stein each take up in their essays. The crisis has dramatically demonstrated that our kind of system, instead of responding to errors and disequilibria by self-correcting, gradually or quickly, can magnify initial errors many times, and then spread them by contagion throughout the financial system and even to areas of the real economy that seem remote from the initial source: witness the path from housing bubble to general crisis. The patent contradic-

tion of the assumptions that have stood behind a generation of Reagan/Thatcher “let the markets rule” policies – and the intellectual framework behind those policies, associated with Milton Friedman in an earlier era and Alan Greenspan more recently – is enormous.

A second, less obvious lesson is that an elaborate financial system, with its mysteries, its glamour, its possibilities for instant wealth, can quietly distort the direction of the real economy; it can induce the real economy to spend human and material resources on activities that can lead to immense private profit for some of those engaged while nonetheless making little or no contribution to general well-being. Some of the following articles, in particular, essays by Benjamin M. Friedman, Lucian A. Bebchuk of Harvard Law School, and Barry Eichengreen of the University of California, Berkeley, focus on these dangers and the search for public policies that can fend them off with minimal handicap to efficient financial activity.

As we saw during the yearlong debate over what finally became the Dodd-Frank Wall Street Reform and Consumer Protection Act (passed by Congress in July 2010), attempts to legislate effective limitation and regulation of financial activities – in the search for a viable combination of efficiency and protection – run into the formidable lobbying power and political clout of the financial industry itself. In their essay, Nolan McCarty of Princeton University, Keith T. Poole of the University of Georgia, Thomas Romer of Princeton, and Howard Rosenthal of New York University provide insight into the challenge of regulating finance in the face of political forces. Nor has the lobbying abated now that the numerous agencies charged by Dodd-Frank with making new rules, and otherwise implementing the changes that the law

mandates, have begun their work. The widening inequality of income and wealth in the United States has consisted largely of an enormous increase in the incomes of those at the very top of the heap, the best-off 1 percent or (even more so) one-tenth of 1 percent, with near stagnation lower down. Those tippy-top incomes are often pocketed by the leading figures in the financial services business. They are not likely to give them up without an all-out fight; and those same deep pockets can generate a lot of political leverage, in both parties. The optimistic view is that we are lucky to have got as much as we did by way of improved regulation out of the stonewalling, horse-trading, and dependence on “contributions” that pervade today’s Congress.

With or without new regulation, disruption in the financial system will inevitably disrupt the real economy from time to time. So will other disturbances, like the occasional sharp increase in world oil prices or simply a turn toward pervasive pessimism among business executives deciding on their firms’ capital spending programs. Two of the following articles, by C.A.E. Goodhart of the London School of Economics and Robert E. Hall of Stanford University, reconsider the standard defenses against shocks to the real economy: monetary policy and fiscal policy. Now that the worst of the financial crisis is behind us, and the debate over financial reform has been consummated in the Dodd-Frank legislation, these policies have become the focus of much of the current economic debate.

Monetary policy, which today means mostly interest rate policy – the domain of the U.S. Federal Reserve System and other central banks elsewhere – is naturally more directly connected to financial events; C.A.E. Goodhart thus argues that future monetary policy-makers need

to pay more explicit attention to the riskiness, as well as the volume, of assets held by the financial sector. In the meanwhile, as of this writing, despite record-low long-term interest rates and no sign of inflation anywhere, many observers of U.S. monetary policy, especially in the financial markets, seem terrified that any move toward monetary expansion would soon unleash irresistible inflationary forces. The same fear paralyzed monetary policy-makers in Japan for more than a decade following that country’s financial crisis in the early 1990s, with the predictable result of ongoing economic stagnation. To conclude that, with short-term interest rates at zero, monetary policy can do nothing further is arguable if not necessarily correct; to argue that monetary policy *should* do nothing further seems, under today’s circumstances, hard to fathom.

The analysis of fiscal policy is, in many respects, the same no matter where the shocks to the real economy come from. But Robert E. Hall makes the important point that the hallowed tendency of most central banks to “lean against the wind” means that any expansionary impulse, whether from fiscal policy or elsewhere, is likely to be partially resisted by the Federal Reserve through an increase in short-term interest rates. (One is entitled to ask why this should be so: aren’t the Federal Reserve and the fiscal authorities in Congress part of the same government, trying to do what is right for the same economy? Why should the right hand undo what the left is doing?) In the aftermath of a financial crisis like the one we have just experienced, however, when the Federal Reserve has pushed short-term interest rates all the way to zero and presumably wishes they could go even further, this monetary policy reaction to any fiscal stimulus seems unlikely. Fiscal policy therefore becomes a substantially more effective tool in a deep recession.

This insight makes the immediate state of affairs around the industrialized world more visibly dysfunctional. The United States and the major European economies have barely started to climb out of a serious recession, and they have not even begun to make good the two years of lost growth. Unemployment and excess capacity are still high and persistent. Nobody believes that the next two years look promising. One would think this represents just the sort of circumstance when fiscal policy is at its most potent, and most needed. Yet most of the talk in both the United States and Germany, the Western world's two bellwether economies, is, incomprehensibly, about fiscal contraction: about deficit reduction, to be achieved via lower public spending and, possibly, higher taxes.

True, the United States has a long-term budget imbalance that needs to be addressed (maybe even with legislation enacted now, to take effect later, when the economy has more nearly returned to full employment); but pursuing fiscal retrenchment *now* seems at best perverse, and in sufficient force, a suicidal recipe for renewed and protracted economic downturn. In Europe, some countries – Greece and Portugal, for example – probably will have to undergo deep and lasting recessions, not just because their tax and spending policies have got so far out of line with one another in recent years, but because their prices and costs have drifted far compared with those of other European economies and, as members of the common-currency (Euro) group, they cannot simply alter their exchange rates to correct the problem. But the likelihood of severe weakness in those European economies that have to have it is all the more reason for those that don't, like Germany, to remain strong; not for them to pursue recession-inducing policies, too, merely for their own sake.

In the wake of the financial crisis, it is understandable that consumers and businesses, conscious of vanished wealth and uncertain about the future, would be reluctant to spend. As economists have recognized since observing what happened in the 1930s, such behavior may be individually rational, even if in the aggregate it makes things worse for everyone. Governments, by contrast, are supposed to think about the health of the economy as a whole, and to offset, or more than offset, such temporary deficiencies in demand for what the economy normally produces. Today they instead seem to be poised to reinforce them. Four-legged lemmings no doubt look on with astonishment.