

## John Cochrane on the Dangers of Current Economic Policies

By Dan Richards  
January 19, 2010

*John Cochrane is the AQR Capital Management Professor of Finance at the Booth School of the University of Chicago and the incoming president of the American Finance Association. Cochrane is also author of the widely-circulated article, [How did Paul Krugman get it so Wrong?](#), a response to Krugman's September 2, 2009 New York Times column [How Did Economists Get It So Wrong?](#).*



*Dan Richards interviewed Professor Cochrane on January 4 at the annual meeting of the American Economic Association in Atlanta, GA. This interview is one of a series that Dan conducted at that conference, and we will provide links to videos of his other interviews. Dan is president of Toronto-based Strategic Imperatives.*

**In some of the panels at this conference, I've heard a fairly dire forecast for growth in the US economy, along with pessimistic forecasts for unemployment and calls for a second fiscal stimulus. What is your mid-term outlook for the US economy?**

Not as pessimistic. But keep in mind that I never make forecasts, and therefore can never be proven wrong. I'm going to give you an "on the one hand and on the other hand" response.

I think it's useful to think through these questions. Nobody knows what is going to happen – we are all thinking about what kinds of events can cause what kinds of problems.

I think the basic forecast should be pretty optimistic. What happened to us was a very classic financial crisis and a flight to quality. Everyone wanted cash and government bonds and weren't spending on anything else.

That passed about six months ago. We are seeing financial markets return to normal. We are seeing all those dislocations – all that garbage in the pipes – disappear. Historically, after panics like this, the economy grows quite quickly and comes back faster than anyone expects. That's what I hope will happen and what should happen.



Our dangers are from policy. There is a slight danger of additional defaults – Greece could go down and cause some more turmoil.

The big danger is that we are into astounding deficits with very large government debt. There is a tendency for our government to micromanage and run all sorts of things. The debt could lead to high and distorted taxes.

Debt, taxes and micromanagement leads to slow growth for a while.

My worry is mostly on policy. The economy left alone should recover nicely.

**A lot of attention is still on housing and US real estate. Do those markets concern you?**

Yes, the real estate markets could be in trouble. But there is always a silver lining in every cloud. A sharp decline in real estate prices is a godsend if you are 25 and have a job. In fact, one outcome of the financial crisis is that if you are 25, you get to buy stocks a lot cheaper than I bought them. You get to buy a house a lot cheaper than I bought one.

The decline in house prices is not *per se* that great a calamity. It is very different if we lose housing wealth by prices going down than if they are washed away in a hurricane. Yet the numbers look exactly the same.

Remember, the underlying decline in value in house prices in real estate is not that much of a problem. Some people lose and others gain.

The problem is if the losers drag the rest of us down. If the commercial real estate held in banks and other financial companies leads to bankruptcies and causes chaos and that leads to bailouts by the government – that is the nature of the problem, not the troubles in real estate *per se*.

**You mentioned the broad concern related to sovereign debt. Related to that is the follow-on concern about inflation, and the nightmare scenario is stagflation – low economic growth and inflation. Does that concern you?**

Yes, in fact my biggest worry is stagflation. That is where I am much more pessimistic than everybody else. It is a much bigger possibility than the conventional wisdom.



There comes a moment when inflation is out of the Fed's control. One of the big moments that will do that is when government debt poses an intolerable problem.

The Fed can only affect inflation with the background of a solvent healthy government that can easily raise taxes to pay off its debts.

Once we get into a situation where we are worried about the US government debt, inflation comes and there is nothing the Fed can do about that. I don't think the Fed realizes this and I certainly don't think most of my colleagues realize this, because we are coming off of 50 years of US history where debt was not causing a problem.

Argentineans understand otherwise. When your government is insolvent, you are going to have inflation and there is nothing the central bank can do about it.

That inflation will not come with a boom. Many people assume you get rid of the slack before you can have inflation. Bernanke says this – there is no danger of inflation because there is no slack in the economy. Well, in 1975 there was no slack in the economy either and we got inflation. That can happen again.

**If you were to provide President Obama one piece of advice, what would that be?**

Stop trying to fix everything in such a panic. Sometimes the patient just needs time to heal. As he advocates evidence-based medicine, let's use evidence-based economic policy. In much of our economic policy we spend trillions of dollars on a cocktail party story with precious little evidence for it.

Let's only interfere where we really understand the facts and the consequences.

**You participated recently in a panel at the Council of Foreign Relations on lessons from the Great Depression. What are the similarities and differences between the present day and that era?**

Some of the things are the same. There was a great boom that resulted in a bust. There was a financial panic underlying it. There was a great increase in government regulation and attempts to fix it which may or may not have worked.



But some of the things are different. Let me highlight some of the lessons we learned and are not about to repeat the Great Depression. I'll mention two of them.

All this financial innovation that everyone makes fun of actually made things much, much better than in the Great Depression. Those much-maligned mortgage-backed securities actually made things better. Here's why.

In the Great Depression, if you defaulted on your mortgage, that mortgage was held by your bank in one city and that bank was funded by depositors. When that bank failed the depositors lost their money, and everybody in that city was in trouble. There was no one left in that city who knew how to make loans or who knew which houses were good. This was Ben Bernanke's classic paper on the Great Depression.

Mortgage-backed securitization means that your mortgage is held in securitized form and finally ends up in a hedge fund that is owned by the policeman's pension fund in Finland – a true story. They lose a lot of money. They are unhappy. They didn't like losing a lot of money.

Think about how much better it is when risk is shared around the world. That is what finance is supposed to do. That wave of bank failures that led to collapse in the Great Depression didn't happen here because of the global financial system.

Another thing that was good, as Bernanke said famously, along with Milton Friedman, is that we learned our lessons. The Fed has acted as an open spigot (if anything the criticism is that it has done too much) but it is not repeating its mistakes of the Great Depression by allowing money supply and credit to collapse.

That is why we are not having another Great Depression.

**One of the things that exacerbated the Great Depression was protectionism. We haven't seen that happen at this point in time, although there are some signs. Are you concerned about this?**

It concerns me greatly. My reading of modern scholarship on the Great Depression is that what made it so long and so hard was largely the government's mishandling of policy.



The Smoot-Hawley Tariff Act, everyone recognized at the time, was a terrible idea. Economists have known about that for a long time. But the NRA and both the Roosevelt and Hoover administrations' constant meddling in the economy made matters a lot worse.

To date we haven't seen protectionism as bad as it could be but there are signs of it. There is danger of too much meddling in the economy, but not yet anywhere to the degree of the Great Depression.

At least when it is out to do something outrageous, our administration starts with the importance of free markets and private discipline and how "this is temporary."

Back in the 1930s, you can read the rhetoric – and it's pretty shocking – about how the whole system needed to be fixed. That at least we say we are going to do the right thing gives me great courage.

**There has been criticism of the repeal of Glass-Steagell. After a separation of commercial and investment banking, some claim that rejoining those contributed to the current difficulties. To what extent to you buy into that diagnosis?**

To some degree, but not completely. I don't want to go on record as saying we need to bring back all of Glass-Steagell

The central part of Glass-Steagell that is good and needs to be revived is a rule-based separation between systemically important dangerous activities that the government must guarantee, and all the betting and investing and other things that can and must be let go on their own.

That has to be by rules. If you simply say "go do what you want and we'll regulate them," you know what's going to happen. If your kids want ice cream and you've gone by the ice cream parlor, you are going to stop for ice cream, no matter what you've said to them. There needs to be a rule.

The rest of Glass-Steagell got us into trouble. I certainly don't think that Glass-Steagell word-for-word should be brought back.

One of the biggest troubles was that it regulated interest rates. The idea was that banks could not charge more than a certain interest rate, in order to make banks more profitable. When inflation came, that fell apart. That is one of the reasons Glass-Steagell fell apart.



Other parts of regulation from the 1930s, such as the prohibition on branch banking, made our financial system much worse. Deregulation actually helped us a lot this time around. When banks failed, large national banks came around and could buy them swiftly. That wasn't allowed in the Great Depression.

Some of the aspects of that regulation were a good idea, for example rule-based regulation of systemic and non-system activity. But a lot of the rest of it had to go.

**You have written about portfolio construction in the new financial world, and you've indicated that there has been a lot of criticism of the Capital Asset Pricing Model (CAPM) as not being relevant. Let's begin by defining exactly what is meant by the CAPM.**

It's an important benchmark for people to keep in mind when they think about their portfolios.

The CAPM says you can get greater returns on some kinds of stocks than others, but when you do that you are taking on more risk. The kind of risk you are taking on is that stocks that pay more, like small stocks on average, are more likely to fall by a bigger amount when the market goes down. So you get more return on average, but the downside is when a market falls, these stocks are going to fall even more.

**That is the core principle underlying the foundation of a lot of portfolio construction going into this crisis. Why did it fail?**

The CAPM works very well in understanding many kinds of investments. With small stocks you get a greater return but you will find that they do worse in market downturns. But we have found empirically that there are other classes of stocks that earn greater returns but don't have these tendencies. And that's the so-called failure of the CAPM.

It works well in many situations. It is a good starting point, but there are others where it doesn't work well and that may point to some investors to do different things with their money.



**Going forward, we have heard talk about portfolio construction in the new financial order. How does that differ from portfolio construction in the old financial order?**

In lots of ways. Let me make three big points that I would encourage people to think about when reflecting on how we understand the world now.

Principle one is to buy the equivalent of “house insurance.” When you buy a home, before you do anything you must buy insurance. Sometimes that insurance isn’t a great deal. You pay premiums and they don’t pay off that much. But it is a risk reduction.

There is a portfolio counterpart to this. If you own say, a steel business, you should not be investing in the steel industry. Why not? It may be a great industry to invest in for someone who doesn’t own a steel business. But you don’t want your business to fail at the same time as the steel business fails.

**Lots of people in the tech boom discovered that their 401(k) plans were invested too heavily in company stocks.**

There is a huge mistake of putting too much money in your own company, industry or stocks that correlate with your own industry. If you are in the oil industry, you should not be buying oil as a commodity, because when the price of oil goes down, your job, business and portfolio will suffer.

This is diversification and it is free. There’s no loss in expected return from doing this. Many advisors jump to what is the magic alpha or the new way to beat the market before doing the basic homework of insuring your risk.

It’s principle one and it is the most important and underappreciated thing

Principle two is to think for the long run. Most investors have 10 or 20 years in mind for their investment objectives. Much of the theory and the old way of doing things didn’t distinguish between short- and long-run results.

Let me tell you a story to make this clear. Suppose you want to send your child to the University of Chicago 10 years from now – a good thing! The risk-free way to do this, to make sure you pay our hefty tuition, is to invest in a 10-year indexed zero-coupon bond – TIPS.



You put the money down and in 10 years you have the money to pay the tuition. Problem solved.

But now here's the mistake many investors make. A new crisis happens and interest rates go up. Of course the value of your investment just fell like a stone.

You open the envelope and panic and say "oh my goodness, we've lost all our money and we can't afford to send our kid to the University of Chicago any more."

Of course, this is absolutely false, because when the price of a 10-year bond goes down the yield goes up and you will still have exactly the same money at maturity.

But your investment objective was to hold to maturity. If you need the money a year from now, this was a bad investment. But if you need the money 10 years from now, the 10-year TIPS was the risk-free asset.

So long as you remember to not open the statements.

**A lot of people – investors and advisors – when they hear “invest for the long run” they equate that with advice to buy-and-hold. There has been lots of criticism that somehow buy-and-hold no longer applies. What is your view on that?**

Buy-and-hold holds a lot more than people think it does. Many very sophisticated investors are regretting their panic in the financial crisis, when they sold at the bottom because they didn't understand that many things that had fallen in value would recover based on their investment objective.

My bond story was to show that this principle applies more generally: think for the long run. Don't think one-by-one and panic.

Put in a plan for the long run and hold, rather than necessarily buying-and-holding. But most investors I know, especially wealthy and very sophisticated ones, do far too much fiddling around.

I think buy-and-hold is fairly sensible advice.



### **And principle three?**

Finally we can have some fun! It is true that the CAPM doesn't work, but it works better than you think. If someone is promising better returns, the first question is what is your beta? Did you synthesize those great returns by simply leveraging up a passive index?

But there are strategies that will pass that test. Let me use value stocks as an example. It is true and 20 years of empirical work has found that value stocks outperform and they don't have a greater beta – a greater tendency to fall off when the market falls off. Of course they also fall; they are not entirely risk-free.

For you to invest in value stocks, you are taking on another dimension of risk. There will be a time when the market has gone up and your value stocks have fallen. You have to face your buddies and say what a stupid thing you did. But there will be more times when the market was flat and value stocks went up.

Value is a great example. There are other dimensions of risk you can think about taking if they are appropriate for you that generate a premium that isn't explained by the market.

But that comes only as step three. First, make sure you are not neglecting "house insurance." Second, make sure you are thinking for the long run and not panicking over the short term. Check that your investments really do outpace the market in a good old CAPM way.

Finally, do some fun things like value investing where you can take on other dimensions of risk – not pure profit - and enhance your portfolio.

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>