

## Nouriel Roubini on Crisis Economics

By Michael Edesess

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There's good reason why Nouriel Roubini has been dubbed Dr. Doom. After reading his book co-authored with Stephen Mihm, *Crisis Economics*, I despair for our economic system.

Not that it screams gloom and doom on every page – it doesn't. The book is a pragmatic, even occasionally routine and boring analysis of financial crises, particularly the recent one, and what to do about them.

The details as explained by Roubini and Mihm, however, make the recent crisis seem inevitable, hard to stop, and very hard to keep from happening again.



Nouriel Roubini

### Ratings agencies

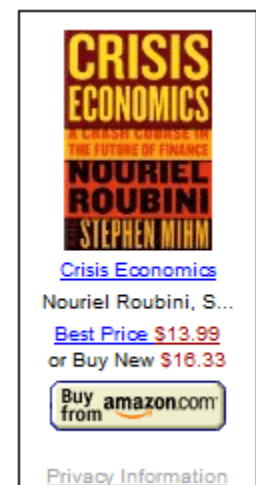
Here is just one example. The ratings agencies, chiefly Moody's, Standard & Poors, and Fitch, originally charged bond investors for ratings. But bond investors could avoid paying by cadging ratings from other bond investors. So the ratings agencies started charging bond issuers instead.

That brought about major conflict of interest problems. Roubini and Mihm offer the analogy of a professor who charges students to take his course and receive a grade. If other professors offer the same course, students will flock to the professor who gives the highest grades. Those who give lower grades will have no students and earn no money. Hence, grade inflation is inevitable.

Similarly, if a rating agency doesn't offer high ratings, it will lose business to those who do.

Presto, you get ratings agencies competing with each other to give high ratings, and even advising their clients – bond issuers – (for a fat fee, of course) on how to obtain high ratings.

Roubini and Mihm discuss various remedies for this situation – virtually all requiring government intervention – but somehow I don't believe they'll work. The authors admit that some of them won't work – for example, going back to the original model in which investors pay the ratings agencies. Others feel like trying to nail jelly to a wall. We know now how great is the ability of the financial industry to do end-runs around regulation.





## **The incentive system**

Roubini and Mihm think the problem at the heart of the financial crisis is the industry's incentive system. A system in which traders and other employees receive gigantic bonuses if they make a lot of money for the firm in one year, but do not give any of it back if the same trades lose even more the next year, is doomed to fail.

They are undoubtedly right, but the system is resistant to fixing. Employees will always go to the firm that offers the biggest and most short-term bonuses. So the problem won't be fixed even if individual firms want it to be, because they'll continue to be trapped in a race to the bottom. Hence, government must be involved in regulating compensation. Again, the jelly-to-the-wall problem: regulation can be gotten around or gamed.

## **The principal-agent problem**

Most pervasive in the system as it has evolved is the principal-agent problem. In its simplest form, imagine that the absentee owner of a small store hires a single employee, a cashier, to check out customers, collect payments and keep the accounts. The owner is the principal and the cashier is her agent. The cashier will know all the information about the store and its accounts and the owner will know nothing except what the cashier tells her. This goes on for years.

In a situation like this, the agent has every incentive not to represent the owner's interests, but to cheat the owner. The cashier can keep cheating the owner by passing the owner bad information. The cashier might even invent a kind of jargon (perhaps developed by an association of certified cashiers that meets regularly at garden spots) in which the cashier explains things to the owner in a way that obfuscates the real situation. That is the principal-agent problem in a nutshell.

In the financial world – with the most elaborate example being the chain of intermediaries that was involved in creating and distributing CDOs (collateralized debt obligations) – practically everybody is somebody else's agent. It's hard even to figure out who exactly the principal is. (I'll come back to this.) Under these circumstances it's easy for associations of agents to build information-obfuscating reasons why they have to keep a lot of the money for themselves.

The opportunities for them to do so abound to a ridiculous extent. Roubini and Mihm make it clear how easy it is for too-big-to-fail banking institutions, like Goldman Sachs and several others, unencumbered by the Glass-Steagall act, to make a lot of money on proprietary trading and other activities because of the information they have – about clients, about government plans (since the top employees, particularly of Goldman Sachs, pass seamlessly between government and financial institutions), and about the operation of other important players in the industry. When you have this kind of information you can



– and do – make money as a firm by taking not only the very appreciable amounts of money that your clients pay you, but the money they lose because they don't have the information you have about themselves and your other clients.

### **The government solution**

At the outset, Roubini and Mihm do an admirable job of touching on alternative theories of the treatment of crises. They identify two issues: the handling of crises when they occur, and the prevention of crises.

As to the handling of crises, on the one hand are the Keynesian economists, who believe crises require massive government intervention to sustain economic activity when it threatens to grind to a halt. On the other hand is the Austrian school – now much smaller than the Keynesian school – that believes “creative destruction” is a good thing and should be allowed to play out.

It has been assumed by a wide range of economists – Ben Bernanke, an expert on the Great Depression, first among them – that we must do anything in our power to prevent a recurrence of the Great Depression and its aftermath, arguably including World War II, probably the most devastating occurrence in history. Had it not been for the experience of the Great Depression, the highly intrusive measures that Bernanke himself initiated (and that are covered well in Roubini and Mihm's Chapter 6) would not have been set in motion. Creative destruction would have occurred instead, to a much greater degree than it has occurred in 2008, 2009 and 2010.

Roubini and Mihm are clearly among those economists who believe government had to step in and do what it did to alleviate the crisis. On the prevention side, they are advocates of massive government intervention. This is the flip side of massive government intervention to alleviate crises. If government is there to bail out risk-takers, it must also heavily regulate them or moral hazard will create ever bigger crises.

The authors are such advocates of government regulation that they say “sometimes it's not enough to impose new regulations on the status quo; sometimes a bit of regulatory ‘creative destruction’ is in order.” So instead of allowing haphazard and uncontrollable creative destruction by doing nothing to alleviate the crisis, governments should precipitate a kind of guided and controlled creative destruction through draconian regulation. They argue that this sort of regulation was imposed after the Great Depression. For example the Banking Act of 1933, also known as the Glass-Steagall Act, established the Federal Deposit Insurance Corporation (FDIC) to federally insure bank deposits and separated commercial banking from investment banking. Until it was gradually eroded by the utopian, fundamentalist free market school of economic thought – exemplified by ex-congressman Philip Gramm – Roubini and Mihm say, it stood us in good stead for 60 years.



## Regulating the regulators

How do you assure good regulation? Just as the mathematical models used in the financial industry were no better than the people who applied them and required judicious use to have any validity at all, regulation requires judicious application. Regulators must be given some scope to apply regulation as they see fit, and must do so intelligently. That means that regulators must be equally sophisticated and knowledgeable about the financial industry as the people they are regulating.

This is a problem when regulators are paid one-hundredth as much as the people they regulate – especially in a society that seems to believe money is the figure of merit for everything. Roubini and Mihm point out that “Until very recently, regulators have been told they’re chumps for not going to work in the private sector. They’re fools who can’t compete with the financial geniuses on Wall Street. Worse, they’re an impediment and an obstacle to the brave new world of financial innovation.”

This attitude has to change drastically for regulation to work. Roubini and Mihm offer several suggestions. The only one that really stands a chance of working, as a practical matter, is simply for regulators to be people of high moral rectitude and motivation – virtuosity – and proud of it. Unfortunately, that means that regulators would have to somehow stand apart from the *homo economicus* that Roubini and Mihm, like all economists, assume normal human beings to be.

## The other side of the coin

When the pendulum swings it’s worth considering where it has swung from. That brought me to [this youtube video](#) showing the late Nobel Prize winner Milton Friedman arguing that the Consumer Products Safety Commission – a U.S. federal agency that works to ensure consumer product safety – is a wasteful government boondoggle filled with snooping bureaucrats. (Elsewhere he gave the same treatment to the US Food and Drug Administration, the FDA.)

Even if his disciple Alan Greenspan is contrite, Friedman, if he were alive, would probably still not approve the idea of government bureaucracies to protect consumers against the financial industry. Toward the end of the video he says why:

“Consumers don’t have to be hemmed in by rules and regulations. They’re protected by the market itself. They want the best possible products at the lowest price. And the self interest of the producer leads him to provide those products in order to keep customers satisfied. After all, if they bring goods of low quality here, you’re not going to keep coming back to buy. If they bring goods that don’t serve your needs, you’re not going to buy them. And therefore they search out, all over the world, the products that might serve your needs



and might appeal to you. And they stand in back of them, because if they don't, they're going to go out of business."

This sounds ludicrous now when applied to the financial industry. Why is it so ludicrous? Why can't the consumers of financial products regularly reject the bad and embrace the good, driving purveyors of bad products in the financial industry out of business and patronizing only the providers of good products?

Again the culprit appears to be the principal-agent problem – as Roubini and Mihm partially point out. But to see that, we must ask exactly who *is* the principal?

That question is answered in part in a recent article by Roger Lowenstein in *The New York Times* titled, [The Next Crisis: Public Pension Funds](#). The principal is of course investors, who paid all the fees to all the mortgage originators, appraisers, packagers, ratings agencies, distributors and what-not, on the chain of intermediaries in the subprime debt house of cards. They also suffered the losses when the investments failed. A large number of the investors were participants in pension funds and other retirement funds. Those funds and their participants are now in deep trouble.

Those investors entrusted their investments to agents: the administrators of the funds, their consultants, and the money managers and investment vehicles that the consultants picked for the administrators. It's a cozy group of agents who all make good livings, while the investors lose. They're the ones who decided that the investors should invest in CDOs. They're the ones who claim – or pretend – to have arcane information about which they are expert, and who represent themselves as qualified to make choices for the investors for very substantial fees.

Something is wrong with this situation, but the solution is not obvious. There's a lack of good information in the hands of actual investors, and too much misinformation. Some advisors act in the best interests of investors and others don't, but the investors can't tell the difference.

I like the way Roubini and Mihm dispose of one piece of misinformation, the "alpha" scam, by simply calling it "schmalpha." The alpha scam is the implication that smart and well-paid financial advisors and managers will procure "alpha" – above-average returns – for their fees. But how many investors know that they're being sold "schmalpha"? Precious few, unfortunately.

This situation will require more than just government regulation. It will require an entire change of mind-set. How this change in mind-set will come about I don't know. Perhaps it needs to be led by creatively destructive government regulation. But it will have to go well beyond that.



In my view, what the financial industry needs is another C. Everett Koop – the U.S. Surgeon General who looked like a wrathful God in uniform, and pushed a major government-led crackdown on the mendacious and injurious tobacco industry. The crackdown included outlawing misleading forms of advertising, as well as requiring very forceful warnings on cigarette packs. Somebody with great moral authority and backed up by clout – perhaps legislative or regulatory authority – needs to start calling a spade a spade in the financial industry, not just once but repeatedly, over and over again.

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