

Recommendations for Further Reading

Timothy Taylor

This section will list readings that may be especially useful to teachers of undergraduate economics, as well as other articles that are of broader cultural interest. In general, the articles chosen will be expository or integrative and not focus on original research. If you write or read an appropriate article, please send a copy of the article (and possibly a few sentences describing it) to Timothy Taylor, preferably by e-mail, at taylort@macalester.edu or c/o Journal of Economic Perspectives, Macalester College, 1600 Grand Ave., Saint Paul, Minnesota, 55105.

The Credit Crunch

Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson lay out “The Origins of the Financial Crisis.” “The financial crisis that is wreaking havoc in financial markets in the U.S. and across the world has its origins in an asset price bubble that interacted both with new kinds of financial innovations that masked risk, with companies that failed to follow their own risk management procedures, and with regulators and supervisors that failed to restrain excessive taking. . . . The erosion of mortgage lending standards stands out as something that could and should have been stopped, especially when there were fears of a housing bubble. . . . We know from economic theory that markets with information asymmetries are trouble and the compounding layers of securitization seem to have been designed to exacerbate this problem.” Initiative on Business and Public Policy at Brookings, Fixing Finance Series—Paper 3, November 2008. At http://www.brookings.edu/~media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf.

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Lawrence H. White asks “How Did We Get into This Financial Mess?” “The expansion in risky mortgages to underqualified borrowers was encouraged by the federal government. The growth of ‘creative’ nonprime lending followed Congress’s strengthening of the Community Reinvestment Act, the Federal Housing Administration’s loosening of down-payment standards, and the Department of Housing and Urban Development’s pressuring lenders to extend mortgages to borrowers who previously would not have qualified. Meanwhile, Freddie Mac and Fannie Mae grew to own or guarantee about half of the United States’ \$12 trillion mortgage market. Congressional leaders pointedly refused to moderate the moral hazard problem of implicit guarantees or otherwise rein in their hyperexpansion . . . The credit that fueled these risky mortgages was provided by the cheap money policy of the Federal Reserve. . . . The actual causes of our financial troubles were unusual monetary policy moves and novel federal regulatory interventions.” Cato Institute Briefing Papers no. 110, November 18, 2008, at http://www.cato.org/pub_display.php?pub_id=9788.

Andrew W. Lo discussed “Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008” in his testimony before the Committee on Oversight and Government Reform of the U.S. House of Representatives. “The most pressing regulatory change with respect to the financial system is to provide the public with information regarding those institutions that have ‘blown up’, i.e., failed in one sense or another. This could be accomplished by establishing an independent investigatory agency or department patterned after the National Transportation Safety Board, e.g., a ‘Capital Markets Safety Board’, in which a dedicated and experienced team of forensic accountants, lawyers, and financial engineers sift through the wreckage of every failed financial institution and produces a publicly available report documenting the details of each failure and providing recommendations for avoiding such fates in the future.” November 13, 2008. At http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217.

V. V. Chari, Lawrence Christiano, and Patrick J. Kehoe offer “Facts and Myths about the Financial Crisis of 2008.” “The financial press and policymakers have made the following three claims about the nature of the crisis. 1. Bank lending to nonfinancial corporations and individuals has declined sharply. 2. Interbank lending is essentially nonexistent. 3. Commercial paper issuance by nonfinancial corporations has declined sharply, and rates have risen to unprecedented levels. Here we examine these claims using data from the Federal Reserve Board and Bloomberg. Our argument that all three claims are false is based on data up until October 15, 2008. . . . We now document three facts about the way the financial system intermediates funds between households and corporate businesses. 1. In the aggregate nonfinancial corporations can pay their capital expenditures entirely from their retained earnings and dividends without borrowing from banks or households. 2. In the aggregate, increases in nonfinancial corporate debt are roughly matched by increases in their share repurchases. 3. Only about 20% of nonfinancial corporate debt is held by banks.” Federal Reserve Bank of Minneap-

olis Research Department, Working Paper 666, October 2008. At <http://www.minneapolisfed.org/research/WP/WP666.pdf>.

John Cassidy profiles the “Anatomy of a Meltdown: Ben Bernanke and the financial crisis.” “‘Under Ben’s leadership, we have felt compelled to create a new playbook for the Fed,’ Kevin Warsh, a Fed governor who has worked closely with Bernanke, told me. ‘The circumstances of the last year caused us to cross more lines than this institution has crossed in the previous seventy years.’ Paul Krugman, the Times columnist, a former colleague of Bernanke’s at Princeton, and the winner of this year’s Nobel Prize in Economics, said, ‘I don’t think any other central banker in the world would have done as much by way of expanding credit, putting the Fed into unconventional assets, and so on. Now, you might say that it all hasn’t been enough. But I guess I think that’s more a reflection of the limits to the Fed’s power than of Bernanke getting it wrong. And things could have been much worse.’” Cassidy also quotes from a talk that Bernanke gave in 2005 after joining the Fed: “The biggest downside of my current job is that I have to wear a suit to work. Wearing uncomfortable clothes on purpose is an example of what former Princeton hockey player and Nobel Prize winner Michael Spence taught economists to call ‘signalling.’ You have to do it to show that you take your official responsibilities seriously. My proposal that Fed governors should signal their commitment to public service by wearing Hawaiian shirts and Bermuda shorts has so far gone unheeded.” *New Yorker*, December 1, 2008, at http://www.newyorker.com/reporting/2008/12/01/081201fa_fact_cassidy.

Michael Lewis follows up on some themes of his book *Liar’s Poker* and introduces some intriguing characters in the current credit crunch in “The End.” Lewis asked “who had anticipated the cataclysm and set themselves up to make a fortune from it. There’s a long list of people who now say they saw it coming all along but a far shorter one of people who actually did. Of those, even fewer had the nerve to bet on their vision. It’s not easy to stand apart from mass hysteria—to believe that most of what’s in the financial news is wrong or distorted, to believe that most important financial people are either lying or deluded—without actually being insane. A handful of people had been inside the black box, understood how it worked, and bet on it blowing up. [Meredith] Whitney [of Oppenheimer Securities] rattled off a list with a half-dozen names on it. At the top was Steve Eisman. . . . Upbeat and Eisman didn’t occupy the same planet. A hedge fund manager who counts Eisman as a friend set out to explain him to me but quit a minute into it. After describing how Eisman exposed various important people as either liars or idiots, the hedge fund manager started to laugh. ‘He’s sort of a prick in a way, but he’s smart and honest and fearless.’” *Condé Nast Portfolio*, December 2008. At <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom>.

Barry Eichengreen and Richard Baldwin have edited *What G20 Leaders Must Do to Stabilise our Economy and Fix the Financial System*, which offers 17 short essays by prominent economists from around the world. Alberto Alesina and Guido Tabellini: “The urgent need is for coordinated action to stimulate the global economy

with fiscal and monetary measures.” Refet S. Gürkaynak: “[A] unified financial regulatory framework for the whole world is unattainable and undesirable. Leaders should waste no time on this; national financial systems vary too widely and some are already over-regulated.” Guillermo Calvo: “The crisis is spreading to the ‘South’. To offset ‘sudden stop’ disruptions, multilateral lending capacity should rise fivefold. Credit lines, like those extended by the Fed to struggling nations, need to be paired with regulations to discourage capital flight, and capital controls more generally should be viewed as useful tools for particular circumstances.” Other contributors include Dani Rodrik, Michael Spence, and Raghuram Rajan. November 2008, at http://www.voxeu.org/reports/G20_Summit.pdf.

Smorgasbord

Robert W. Hahn and Peter Passell discuss “The Economics of Allowing More Domestic Oil Drilling.” From the abstract: “[W]e use a benefit–cost framework to analyze the impact of allowing oil drilling in the Arctic National Wildlife Refuge and the portions of the Outer Continental Shelf that are currently closed to development. We find that development of ANWR and off-limits OCS is likely to have only a modest impact on future world (and thus domestic) oil prices, on the order of one percent. Therefore, we believe that the impact of opening the new resource areas on current prices would be modest as well. Our benefit–cost analysis of developing off-limits OCS suggests that the benefits are very likely to exceed the costs. We are less confident in the case of ANWR, but still believe that the expected benefits of development are likely to exceed the costs.” AEI Center for Regulatory and Market Studies, Working Paper 8-21, Revised September 2008, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1265728.

Theda Skocpol and Suzanne Mettler discuss the effects of U.S. higher education on equality in “Back to School.” More than a third of a century ago, in 1970, 6.2 percent of the U.S. population in the bottom income quartile had completed a baccalaureate degree by age 24—and that percentage actually declined slightly, to 6 percent, by the year 2000. Lower-middle-income young people from the second (to the bottom) income quartile improved their college completion rates only slightly from 1970 to 2000, from 10.9 percent to 12.7 percent. But note the contrasting trajectories for young people in the upper half of the income distribution. For those in the third quartile—solidly middle-class families—completion percentages rose markedly, from 14.9 percent in 1970 to 26.8 percent in 2000. And for the most privileged young people, those from upper-middle-class and upper-class families in the top quarter of the income distribution, college completion rates rose from 40.2 percent in 1970 to 51.3 percent in 2000. Compared to the mid-twentieth century, higher education is now increasingly exacerbating socioeconomic inequality in the United States. Its success at fostering upward mobility has diminished sharply.” *Democracy*, Fall 2008, pp. 8–18. Available with free registration at <http://www.democracyjournal.org>.

Anthony Landry revisits “The Big Mac: A Global-to-Local Look at Pricing.” “McDonald’s iconic hamburger is a tiny bit of the world economy, but it’s often used as a rough gauge of relative prices across countries. Since 1986, *The Economist* magazine has been publishing a Big Mac Index, comparing the hamburger’s international prices. The index shows how much Big Mac prices vary from one country to the next. What’s less well known is the extent to which Big Mac prices diverge across the U.S., regions, Texas and even Dallas. . . . Big Mac prices’ standard deviation is more than four times larger at the global level than in the U.S. This suggests that international transportation costs, trade barriers and income differences largely influence Big Mac prices between countries. A series of studies have shown that this observation holds across a range of goods.” *Economic Letter: Federal Reserve Bank of Dallas*, September 2008, vol. 3, no. 9. At <http://www.dallasfed.org/research/ecllett/2008/el0809.html>).

Nassim Nicholas Taleb, known for “his examination of Black Swans, the highly improbable and unpredictable events that have massive impact,” describes “The Fourth Quadrant: A Map of the Limits of Statistics.” “Statistical and applied probabilistic knowledge is the core of knowledge; statistics is what tells you if something is true, false, or merely anecdotal; it is the ‘logic of science’; it is the instrument of risk-taking; it is the applied tools of epistemology; you can’t be a modern intellectual and not think probabilistically—but . . . let’s not be suckers. The problem is much more complicated than it seems to the casual, mechanistic user who picked it up in graduate school. Statistics can fool you. In fact it is fooling your government right now. It can even bankrupt the system (let’s face it: use of probabilistic methods for the estimation of risks did just blow up the banking system).” *Edge: The Third Culture*, September 15, 2008, at http://www.edge.org/3rd_culture/taleb08/taleb08_index.html).

Global Inequalities

The *2009 World Development Report* has the theme “Reshaping Economic Geography.” From the Overview: “Place is the most important correlate of a person’s welfare. In the next few decades, a person born in the United States will earn a hundred times more than a Zambian, and live three decades longer. . . . At the national scale, economic growth displays a similar unevenness, as places close to large markets prosper sooner than places more distant. In China the coastal provinces—mainly in the three areas known as the Bohai Basin, the Pearl River Delta, and the Yangtze River Delta—accounted for more than half of the country’s GDP in 2005, with less than a fifth of its area. In Brazil the south-central states of Minas Gerais, Rio de Janeiro, and São Paulo account for more than 52 percent of the country’s GDP, with less than 15 percent of its land area. Greater Cairo produces 50 percent of the Arab Republic of Egypt’s GDP, using just 0.5 percent of its land area. . . . [E]conomic growth is seldom balanced. Efforts to spread it prematurely will jeopardize progress. Two centuries of economic development

show that spatial disparities in income and production are inevitable. . . . The most successful nations also institute policies that make basic living standards more uniform across space. Economic production concentrates, while living standards converge.” Published November 2008. At <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTWDRS/EXTWDR2009/0,,menuPK:4231145~pagePK:64167702~piPK:64167676~theSitePK:4231059,00.html>).

The OECD has published “Growing Unequal? Income Distribution and Poverty in OECD Countries.” “This report looks at the 30 developed countries of the OECD. It shows that there has been an increase in income inequality that has gone on since at least the mid-1980s and probably since the mid-1970s. This widening has affected most (but not all) countries, with big increases recently in Canada and Germany, for example, but decreases in Mexico, Greece, and the United Kingdom. But the increase in inequality—though widespread and significant—has not been as spectacular as most people probably think it has been. In fact, over the last 20 years, the average increase has been around . . . the same as the current difference in inequality between Germany and Canada—a noticeable difference, but not one that would justify talk about the breakdown of society.” Published October 2008. The report can be freely browsed (but not freely downloaded) at <http://www.oecdbookshop.org>).

Interviews

Douglas Clement interviews Christina and David Romer shortly before Christina was announced as the choice for Chairman of the Council of Economic Advisers. David on monetary policy and asset bubbles: “I’ve always been of the view that it’s very hard to identify an asset price bubble, and I don’t think the Fed should be in the business of trying to determine what fundamental values are. A nice concrete example of this is that when Alan Greenspan gave his famous irrational exuberance speech, the Dow-Jones average was at something like 6,000; it eventually fell, but it had risen a great deal more before it fell. So in retrospect it looks like 6,000 was not too high for the Dow at that time. . . . [I]t might be best to think not in terms of trying to manage asset prices or identify fundamental values, but rather that rapid increases in asset prices are another indicator of potential overheating that the Fed might want to consider in how it conducts policy.” Christina on recent Fed policy: “The Fed was created because we’d gone through several devastating financial panics in the late 1800s and early 1900s. So, faced with what could have turned into a panic in 2008, the Fed responded aggressively. It’s exactly the textbook description of what they should have done. Now the innovative things, such as lending to investment banks, raise big regulatory issues that I think someone needs to be thinking about a lot—making sure they’re dealing with them correctly. But again the big picture was, don’t let the New York financial market go under because it would have devastating real economic consequences. That was exactly the right focus for policy.” Christina on their professional collaboration:

“We often say that the professional collaboration solved all the bargaining issues in the marriage. Normally it’s, Who does the laundry? or Who washes the dishes? Well, for us it’s, I’ll wash the dishes, I’ll play with the kids, you go write the computer program. Given that there’s lots of work to do, it certainly makes it easy to negotiate over who does what.” *The Region: Federal Reserve Bank of Minneapolis*, September 2008, pp. 13–22, at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4048).

Brian M. Carney describes a conversation with Anna Schwartz in “Bernanke Is Fighting the Last War.” In Schwartz’s words: “[F]irms that made wrong decisions should fail. . . . You shouldn’t rescue them. And once that’s established as a principle, I think the market recognizes that it makes sense. Everything works much better when wrong decisions are punished and good decisions make you rich.” “It’s very easy when you’re a market participant . . . to claim that you shouldn’t shut down a firm that’s in really bad straits because everybody else who has lent to it will be injured. Well, if they lent to a firm that they knew was pretty rocky, that’s their responsibility. And if they have to be denied repayment of their loans, well, they wished it on themselves. The [government] doesn’t have to save them, just as it didn’t save the stockholders and the employees of Bear Stearns. Why should they be worried about the creditors? Creditors are no more worthy of being rescued than ordinary people, who are really innocent of what’s been going on.” *Wall Street Journal*, October 18, 2008. At <http://online.wsj.com/article/SB122428279231046053.html>).

Stephen Slivinsky has an “Interview” with Charles Holt. Holt on classroom experiments: “For me, experiments provide a hands-on connection between the beauty of economic theory and actual human behavior. The auctions and games I use in research are great for adding excitement to economics classes, which otherwise can be dauntingly theoretical. . . . Those who have been in the auction or market have seen the economic process from the inside, learned lessons the hard way, and class discussions are often lively and focused as a result. There’s no better way to teach notions like opportunity cost or sunk cost when some of the students have earned 40 percent less than some of their classmates who priced correctly. In case you’re wondering, I pick one person at random afterward and pay them some small fraction of their earnings.” There are also interesting (if difficult to excerpt) comments on several auctions: for a program to pay Georgia farmers not to irrigate; for wireless spectrum; and for rights to greenhouse gas emissions among electric power generators in the northeastern United States. *Region Focus: Federal Reserve Bank of Richmond*, Spring/Summer 2008, pp. 32–35. At http://www.richmondfed.org/publications/research/region_focus/2008/spring/pdf/interview.pdf).

On-line Lectures

Six lectures in economics are available on-line from the Nobel Laureate Meetings at Lindau held in August 2008: Muhammed Yunus, “Social Business is the Solution”; Joseph Stiglitz, “Economic Theory and the Current Economic Crisis”;

Myron Scholes, “The Role of Liquidity and Risk Transfer Services in the Economy”; Edmund Phelps, “Understanding Dynamism: Sources and Benefits”; Roger Myerson, “Leadership, Trust and Power: Dynamic Moral Hazard in High Office”; and Robert Solow, “Low-wage Work in Europe and America.” Go to (<http://www.lindau-nobel.de>), click on “Lectures Online,” and follow the links.

Robert Shiller’s undergraduate course on “Financial Markets” from Spring 2008 is available at Open Yale Courses, at (<http://oyc.yale.edu/economics/financial-markets>). The 26 class sessions of 75 minutes each include not only Shiller’s explanations, but also guest lectures from David Swenson, Carl Icahn, Andrew Redleaf, Stephen Schwarzman, and two from Lawrence Summers.

Discussion Starters

Ian Angus provocatively re-considers “The Myth of the Tragedy of the Commons.” “Since its publication in *Science* in December 1968, ‘The Tragedy of the Commons’ [by Garrett Hardin] has been anthologized in at least 111 books, making it one of the most-reprinted articles ever to appear in any scientific journal. . . . For 40 years it has been, in the words of a World Bank Discussion Paper, ‘the dominant paradigm within which social scientists assess natural resource issues’ . . . It’s shocking to realize that he provided no evidence at all to support his sweeping conclusions. He claimed that the ‘tragedy’ was inevitable—but he didn’t show that it had happened even once. Hardin simply ignored what actually happens in a real commons: self-regulation by the communities involved. . . . The success of Hardin’s argument reflects its usefulness as a pseudo-scientific explanation of global poverty and inequality, an explanation that doesn’t question the dominant social and political order. It confirms the prejudices of those in power: logical and factual errors are nothing compared to the very attractive (to the rich) claim that the poor are responsible for their own poverty. The fact that Hardin’s argument also blames the poor for ecological destruction is a bonus.” The website of *Monthly Review*, August 25, 2008, at (<http://www.monthlyreview.org/mrzine/angus250808.html>).

The November 2008 issue of *Cato Unbound* focuses on the topic: “When Corporations Hate Markets.” In the lead essay, “Corporations versus the Market; or, Whip Conflation Now,” Roderick Long asks: “Defenders of the free market are often accused of being apologists for big business and shills for the corporate elite. Is this a fair charge? No and yes. Emphatically no—because corporate power and the free market are actually antithetical; genuine competition is big business’s worst nightmare. But also, in all too many cases, yes—because although liberty and plutocracy cannot coexist, simultaneous advocacy of both is all too possible.” Lively comments follow from Matthew Yglesias, Steven Horwitz, Dean Baker, and others. At (<http://www.cato-unbound.org/archives/november-2008-when-corporations-hate-markets>).

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