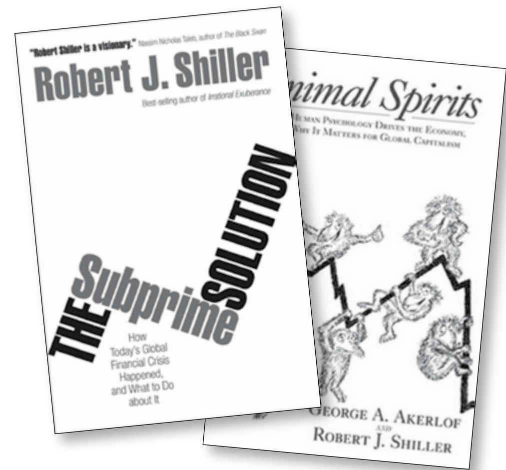
AUTHORITARIAN ECONOMICS

Robert Shiller uses behavioural economics to justify repressive policies, warns **Stephen Kirchner**



The Sub-Prime Solution

By Robert Shiller
Princeton: Princeton University Press, 2008

Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism

By George Akerlof and Robert Shiller
Princeton: Princeton University Press, 2009

Robert Shiller is a leading exponent of behavioural economics and has enjoyed increased prominence in the wake of the global financial crisis. The crisis has been widely interpreted as discrediting mainstream economics and the efficient markets hypothesis. But Shiller's two post-crisis books, *Subprime Solution* and *Animal Spirits* (with George Akerlof), show that the behaviouralist economics project is analytically bankrupt and has been hijacked by an authoritarian political agenda. Economic behaviouralism now serves mainly as a device to sidestep mainstream economic theory and evidence and to reinstate discredited economic doctrines.

Subprime Solution illustrates the extent to which New Deal mythology still has a stranglehold on contemporary thinking about the recent financial crisis. Shiller romanticises the New Deal, maintaining that 'somehow a spirit of cooperation and change developed … ultimately embodied in the New Deal; while there was great unrest, there was also a sense of positive institutional change and progress, which offset the despair of the Depression. Hostility between labour and management, and between rich and poor, was tempered by the sense that we were all moving together toward a more enlightened world.' (p. 99) But as Amity Shlaes demonstrates in her history of the Great Depression, *The Forgotten Man*, the New Deal was anything but cooperative and enlightened.[1]

Shiller sees the New Deal as a model for approaching many of the issues raised by the credit crisis: 'the soundness of the ideas implemented in response to the financial crisis of the 1930s is evident in the durability of the institutions created.' Shiller cites the government-sponsored enterprises Fannie Mae and Freddie Mac as examples of these institutions (pp. 13 and 106) as well as the Office of Federal Housing Enterprise Oversight (OFHEO), which arose in response

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to the housing crisis of the 1980s and was until recently responsible for regulating Fannie and Freddie. Yet as Shiller himself notes, the 'OFHEO never showed any recognition of the housing boom … regulators did not seem to see the risk and they allowed Freddie and Fannie to go on supporting the housing boom.' (p. 53) These Depression-era institutions not only failed to prevent the most recent housing and financial crisis but were, in fact, deeply implicated in promoting overinvestment in US housing and diffusing sub-prime mortgage debt instruments throughout the international financial system.

Bubble thinking

For Shiller, regulatory failure only reinforces the case for new interventions. He claims that 'we do not understand, or know how to deal with speculative bubbles' (p. 3) and this is the fundamental cause of the recent financial crisis. Shiller maintains that the 'sub-prime crisis was essentially psychological in origin, as are all bubbles. The crisis was not caused by the impact of a meteor or the explosion of a volcano.' (p. 24) Yet Shiller's 'bubble thinking' explanation might as well be a meteor or volcano for the all the light it sheds on the crisis. Shiller suggests that the propagation of 'bubble thinking' relies on 'social contagion' but provides no explanation for why people make what he considers to be systematic and forecastable errors in relation to asset prices.

Not a single asset class has escaped being characterised as a bubble in recent years: stocks, real estate, credit markets, as well as commodity markets such as oil, gold and even uranium have all apparently qualified as bubbles. Shiller maintains that Sydney suffered a burst housing bubble in 2004 on the strength of no more than a 2.4% decline in real house prices.[2] The overuse of the bubble characterisation is a strong indication that the term is empty of analytical content and describes no more than the normal functioning of markets. Shiller himself describes both housing and oil markets as 'inherently and deeply speculative' (p. 63) without realising the obvious implication that speculation is a normal and essential element of market behaviour.

Despite his emphasis on speculative psychology, Shiller often lapses into fundamental explanations of the US housing market, implicitly acknowledging that bubble explanations are inadequate. In addition to the already noted regulatory failures, Shiller observes that the collapse in house prices was concentrated in the lower end of the market where sub-prime lending activity was concentrated. (p. 36) He also notes that 'there are certain basic economic laws that—while they may be bent over shorter intervals—ultimately always assert themselves in the long run.' (p. 34) Shiller's earlier work *Irrational Exuberance* was largely built around the observation that equity valuations tend to revert to historical averages, with the behavioural finance component tacked on in an effort to disguise the fact that he had nothing new to say about the determination of asset prices.

Irrational Exuberance was based on a spectacularly inaccurate prediction Shiller made in 1996, that the S&P 500 stock market index would show no real appreciation over the next 10 years and that 'long run investors should stay out of the market for the next decade.'[3] In the event, between December 1996 and December 2006, the S&P 500 saw annualised returns of 5.89% after inflation and the reinvestment of dividends (4.22% without reinvestment) despite a significant market downturn between 2000 and 2003. Shiller understandably demurred on predicting the future course of the stock market when he published *Irrational Exuberance* in 2000, contrary to the now widely held view that the book 'predicted' the downturn in equity prices in that year. Alan Greenspan's December 1996 'irrational exuberance' speech noted that 'we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy … asset prices particularly, must be an integral part of the development of monetary policy.'[4] But Greenspan also took the view that the Fed should not second-guess the market on asset prices. Greenspan's intellectual humility was vindicated, whereas Shiller's forecast was profoundly mistaken. To his credit, Shiller argues against the widely held notion that easy monetary policy was an exogenous cause of house price inflation. Changes in the US Fed funds rate cannot account for a nine-year uptrend in house prices. (pp. 48–49)

As a leading exponent of behavioural finance, it is ironic that Shiller has no behavioural model. He views a 'speculative bubble' as a sufficient explanation for any observed innovation in asset prices, relying on well-known violations of rationality in financial markets to support his view. The efficient markets hypothesis is analogous to the idea of perfect competition in markets for goods and services. No one believes that any real-world market for goods and services is perfectly competitive, but that does not invalidate the model's analytical usefulness. The same is true of the efficient markets hypothesis. Unfortunately, just as the routine violations of perfect competition are often viewed as automatically justifying government intervention to correct 'market failure,' exceptions to the efficient markets hypothesis are seen as invalidating the role of free markets in allocating capital. Shiller's *Subprime Solution* illustrates how loose thinking about bubbles in asset prices very quickly leads to proposals to replace free markets with permanent regulatory interventions.

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Shiller's proposals

The final chapter of Shiller's book is devoted to a number of proposals designed to promote 'the democratisation of finance,' although some of these proposals could be more accurately characterised as 'the socialisation of risk.' His motivation is to 'reduce the long-run incidence of speculative bubbles.' (p. 115) Taking a leaf out of the literature on free banking, he argues for prices to be quoted in an inflation-adjusted unit of account to cure the 'money illusion' he maintains is partly responsible for bubbles. Yet the idea of inflation-adjusted or real returns as a benchmark for asset prices is already well understood and widely reported in the popular financial press. His call for an improved 'information architecture' in relation to retail and wholesale financial products is not particularly objectionable, but is also an implicit admission that it is imperfect information and not speculative psychology that leads to inefficiencies in asset pricing—exactly what the efficient markets hypothesis would predict.

Shiller has been actively involved in the development of financial derivatives tied to house prices. He maintains that the lack of opportunities for short-selling in real estate has promoted housing bubbles, a view also consistent with the efficient markets hypothesis. Yet there are ample opportunities to short-sell commodities such as oil, and Shiller views these markets as equally bubble-prone.

Shiller's most dangerous proposal is for 'continuous work-out mortgages,' the terms of which would be varied through the life of the mortgage based on economic conditions. These mortgage instruments are aimed at socialising risk. Shiller is well aware of the moral hazard these instruments could create, but argues that 'if it nevertheless encourages undesirable behaviour, it is at least undesirable behaviour whose costs have been covered.' (p. 159) This is small comfort for those who would have to bear these costs. Shiller says we 'must institutionalise generosity to the unfortunate' (p. 174), but the already well-established institutions of the welfare state show disastrous social results when people are freed from the financial and other consequences of imprudent behaviour. In socialising risk, Shiller's proposals would encourage more financial risk-taking, with adverse consequences for the stability of financial markets and the real economy.

Animal Spirits attempts to marry behaviouralism with Keynesian macroeconomics to explain how the economy 'really works,' while making the case for government intervention as a counterweight to the cyclical behaviour of the economy and asset prices. 'Animal spirits' is borrowed from Keynes' *General Theory* and is defined by the authors as 'a restless and inconsistent element in the economy. It refers to our peculiar relationship with ambiguity and uncertainty.' (p. 4) This idea is by no means unique to Keynes, who was clearly influenced by the Chicago School's Frank Knight in distinguishing between quantifiable risks and unquantifiable uncertainties and their implications for economic decision-making.

Akerlof and Shiller maintain that it is animal spirits that drive the business cycle and that mainstream economics neglects the role of psychology, informal narratives, and notions of fairness in influencing economic behaviour. Economists have long used measures of consumer and business confidence to gauge the strength of economic activity. However, when we control for the influence of other economic variables, confidence is usually found to have little or no predictive power for economic activity. The clear implication is that it is economic activity that drives confidence, not the other way around. Akerlof and Shiller are well aware of these results, but argue that 'such tests are actually of limited value' (p. 17) because 'there are no standard ways to quantify the psychology of people.' (p. 140) This is true enough, but it also happens to be just a little too convenient for their argument. Consistent with their focus on 'stories,' Akerlof and Shiller never let the facts get in the way of a good one.

Their claim that 'there is an easy and simple test to prove that what we are saying is correct … we think that our description of how the economy operates fits almost any business cycle' (pp. 168–169) is no test at all. A heavily stylised account that claims to fit every set of business cycle facts is too successful to be credible. It is a theory of everything and nothing. Austrian business cycle theorists also claim they can account for every historical business cycle, but in practice, many Austrian economists have turned their theory into little more than a fundamentalist cult. How are we to adjudicate between these competing accounts?

We need both theory and evidence to support any new theory of the business cycle, but Akerlof and Shiller see no shame in admitting they cannot support their most basic propositions. They freely concede they cannot establish the central claim for which Shiller is most famous, noting that 'one cannot decisively prove that the stock market has been irrational.' Instead, they make an argument that would never be accepted coming from an undergraduate: 'in all of this debate, no one has offered any real evidence to think that the volatility *is* rational.' (pp. 132–133, emphasis in original) In my Centre for Independent Studies Policy Monograph, *Bubble Poppers*, I discuss this very common confusion of volatility with irrationality. Akerlof and Shiller actually undermine the argument in Shiller's *Irrational Exuberance* when they note in passing that 'there has been one way, at least in the past, in which almost everyone could become at least moderately rich … Invest it for the long term in the stock market, where the rate of return after adjustment for inflation has been 7% per year.' (p. 117) This is not what Shiller was telling people in 1996 when he said that 'long run investors should stay out of the market for the next decade.'

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Rejecting mainstream macroeconomics

Akerlof and Shiller implicitly or explicitly reject the major post-War advances in macroeconomic thought in their attempt to rehabilitate discredited economic doctrines. In particular, they argue that there is a long-run trade-off between inflation and unemployment that is attributable to 'money illusion.' They invoke the efficiency wage theory and the well-known inflexibility of nominal wages as evidence for money illusion. Although the failure of labour markets to clear like goods markets is to some extent still an unsolved puzzle in macroeconomics, money illusion is neither necessary nor sufficient to explain it. There are plenty of alternative explanations for the disequilibrium behaviour of labour markets that do not rely on money illusion and the existence of nominal wage rigidities is not necessarily evidence of money illusion.

There is a simple test for the existence of money illusion that Akerlof and Shiller neglect: surveys of consumers' inflation expectations. These surveys suggest that, on average, people have a good understanding of the inflation process. Inflation expectations help forecast future inflation (the coefficient instability noted in a footnote by the authors is an econometric rather than a substantive issue). The whole point of inflation targeting, which the authors believe

causes unemployment (p. 114), is to anchor long-run inflation expectations so as to *minimise* the economic importance of money illusion. In noting that anti-inflationary monetary policies are often associated with increases in unemployment, Akerlof and Shiller in no way invalidate the view that there is no long-run trade off between inflation and unemployment. The authors even suggest that a dated penalty notice on a Boston train is evidence of money illusion (p. 41) instead of the more prosaic explanation that the law has not kept pace with inflation. It is not surprising that the authors patronise Milton Friedman as 'the boy who knew how to spell banana but did not know when to stop.' (p. 108)

Authoritarian economics

In discussing responses to the current crisis, Akerlof and Shiller argue that 'macroeconomic planners … must also make a plan—we might call it a target or an intermediate target—for the amount of credit of different sorts that is to be granted. This target should correspond to the credit that would normally be given if the economy were at full employment. The target should not be merely a mechanical credit aggregate, but should reflect the more general condition that credit be available for those who, under normal circumstances, would be deserving of it.' (p. 89) This is little different from Soviet-style central planning.

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Akerlof and Shiller's authoritarianism is evident in their effusive praise for systems of forced saving in Singapore and China, which they compare favourably to the (mismeasured) saving performance of the United States and other Western economies. They ludicrously suggest that Lee Kuan Yew 'may be one of the most important economic thinkers of the twentieth century. His high-saving economy became a model for China, which has copied Singapore's saving achievement.' (p. 125) Akerlof and Shiller are surely not unaware of the fact that high saving rates in both countries are a function of political and economic repression in which the state overrides individual preferences in relation to consumption and saving, imposes capital controls, manages the exchange rate, and directs investment spending. By implication, Akerlof and Shiller support all these policies, of which high saving rates are but a by-product. They see individuals as incapable of making appropriate choices between consumption and saving. This reflects their view that capitalism 'does not automatically produce what people really need; it produces what they *think* they need.' (p. 26) Left to their own devices, people will undersave, so 'saving policy has an important role in correcting for their failures.' (p. 130) They simply ignore the extensive body of literature showing that Americans do not undersave.[5] They maintain that high saving leads to economic growth, but never consider the equally well-established fact that as income rises, so does financial innovation and the use of debt to smooth lifetime consumption, at least in a free market economy.

Akerlof and Shiller claim that their work 'provides an answer to a conundrum: Why did most of us utterly fail to foresee the current economic crisis?' (p. 167) Yet this supposed 'failure' is entirely consistent with a rational expectations interpretation of the economy. If events such as the global financial crisis could be forecast with any certainty, policymakers and the public would take action to avert them. A crisis is a crisis precisely *because* it is unforeseen. From a rational expectations perspective, these events are unforecastable almost by definition and, to that extent, perfectly explicable. While financial crises are necessarily unforecastable, this does not mean that mainstream economics cannot explain them *ex post*. The behavioural economics of Akerlof and Shiller, by contrast, suffers from an inescapable paradox that arises from their elitist and arrogant assumption that only they know the true model of the economy, while everyone else is trapped in a morass of cognitive bias and confusion. If everyone read Akerlof and Shiller and came to understand the way the economy 'really works,' much of their analysis would no longer apply, unless we assume that people are either incapable of learning or are wilfully ignorant.

With *Animal Spirits*, Akerlof and Shiller have further demonstrated how behavioural economics has been captured by an authoritarian political agenda that is leveraging-off the financial crisis to attack and undermine the basic institutions of a liberal economic order. Behaviouralism now serves mainly as a pretext to dump all that the economics profession has learned over the last 60 years and replace it with an elitist paradigm in which only the anointed few know the true model of the economy and institute policies to give the muddled masses what they really need as opposed to what they think they want. Needless to say, Akerlof and Shiller conclude by stressing 'the urgency for setting up the committees and commissions to develop the reforms in financial institutions and the regulations that are so immediately needed.' (p. 176) However, the uncertainties created by these political interventions will inevitably undermine the very 'animal spirits' that Akerlof and Shiller maintain are crucial to the economy.

Endnotes

1 Amity Shlaes, *The Forgotten Man* (New York: HarperCollins Publishers, 2007).

2 Robert Shiller, 'People are talking,' *The Wall Street Journal* (2 June 2005).

3 Robert Shiller, 'Price-Earnings Ratios as Forecasters of Returns: The Stock Market Outlook in 1996' (21 July 1996), www.econ.yale.edu/~shiller/data/peratio.html.

4 Alan Greenspan, 'The Challenge of Central Banking in a Democratic Society,' Francis Boyer Lecture (Washington, DC: American Enterprise Institute, 5 December 1996).

5 For example, John Scholz, Ananth Seshadri, and Surachai Khitatrakun, 'Are Americans Saving "Optimally" for Retirement?' *Journal of Political Economy* 114: 4 (2006), 607–643.

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