BOOK REVIEW

Gary B. Gorton (2012). *Misunderstanding Financial Crises*: Why We Don't See Them Coming (Oxford and New York: Oxford University Press), pp. 278, (h/b), US $ 29.95, ISBN 978-0-19-992290-1

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Introduction

What are we to make of the discourse of economics given that economists were not able to see the financial crisis coming? That is the main though not the only question that Gary Gorton sets out to answer in this book. Gorton teaches finance at the Yale School of Management, and has served previously as a faculty at the Wharton School, and as a research associate at the National Bureau of Economic Research. He has also worked at the US Federal Reserve and has been a consultant at AIG Financial products. Gorton brings an enormously impressive 'portfolio of experiences' in the financial sector to bear on the questions that he sets out to answer in this book. Not only does he draw upon his understanding of economic history and financial theory to make sense of what went wrong in the global financial meltdown of 2008; he is also interested in asking – what, if anything, can be done to 'reinvent' economics as a source of knowledge about the financial world? What is ultimately at stake then is the 'epistemology of economics' since 'The Quiet Period' that characterized US financial history after the introduction of deposit insurance by the Federal Deposit Insurance Corporation (FDIC) in 1934 had lulled economists into thinking that financial crises (caused especially by bank runs) were a thing of the past. What they overlooked was the possibility that the equivalent of a bank run could still occur in the financial sector; not all financial institutions were 'banks' in the technical sense and therefore not covered by deposit insurance.

The Livingston Doctrine

A lot of people for instance still don't realize that Lehman Brothers was not a bank, but suffered the equivalent of a bank run in the wholesale financial markets, and that since it lacked sufficient collateral, it could not be bailed out by the Fed. Gorton argues that Bear Sterns was bailed out under the Livingston Doctrine that was articulated 'in a legal case Livingston v The Bank of New York'. Fed communications on this matter has however focused more on the Bagehot Doctrine that was articulated in Lombard Street (1873) rather than on the Livingston Doctrine (Bernanke, 2013). The position of the Fed and the US Treasury has always been that before the introduction of the Troubled Asset Relief Program (TARP) by Hank Paulson, it was simply not possible to intervene in the Lehman case (Paulson, 2010). This is a point that is worth discussing further since the Dodd-Frank Act of 2010 restricts the Fed's discretionary power to decide on whether or not to intervene in such cases in the future. Technical experts in this area might also want to consider whether the Dodd-Frank Act incorporates or negates the legal precedent set in the Livingston case, and whether Livingston prescribes the need for a firm being bailed-out to produce sufficient collateral to justify a Fed intervention. The importance of Livingston, I think, is that it does not differentiate between 'too-small-to-fail' and 'too-big-to-fail' since what is really in contention is that 'in times of crisis, bank debt should not be enforced, and banks should not be forced into insolvency'. This is a point that has not been sufficiently discussed in the wake of the crisis since, as Gorton points out, 'a financial crisis in its pure form is an exit from bank debt'; and that no bank can pay off its debtors in its entirety during a bank run even if its debt is backed by sufficient collateral (given that any attempt at a fire-sale of collateral, or even a perception that it is being dumped, will destroy its value)

The Quiet Period

While some aspects of US financial history may be well known to readers, Gorton does a good job of clarifying the basic assumptions, ideas, and techniques of intervention during financial crises. In addition to the Livingston Doctrine mentioned above, Gorton explains the importance of 'The Quiet Period' and how it relates to 'The Great Moderation'. What these periods did (or rather the interpretation of these periods by economists did) was to create the false impression that it is possible to do economic theory without seeking recourse to historical data: this led to the marginalization of economic history in departments of economics. The basic assumptions of economics and financial theory did not include the need to incorporate internal and external shocks to the financial system. Gorton argues that it was not so much the preoccupation with mathematical formalism that was to blame, but the refusal to believe that things could go wrong in the United States. Economists did not see the crisis coming because they did not think that a crisis was possible. Bank runs were an embarrassment from an earlier period in financial history -- not problems that could break out unexpectedly in the wholesale financial markets and create 'a systemic crisis'. The role that was to be played by a whole host of new financial instruments and the lack of sufficient understanding of money markets was not thought-through -- let alone anticipated. It was not possible to see the crisis coming because economists did not expect to see anything unusual. Gorton quotes a line (p. viii) from Sir Arthur Conan Doyle that sums up the situation: 'As Sherlock Holmes put it to Dr. Watson: “You see, but you do not observe.” '

Stability & Instability

There are 14 chapters in this book: it can be read as a foray in either financial history, or as an attempt to read history as a prelude to rethinking financial theory. Those who think it is a theoretical work should start by reading the last chapter first, since it sets out 'the theory and practice of seeing', and read the historical part as a preparation to not only 'see', but to learn to 'observe' in a Holmesian way. Those who believe that this is a historical work will see the last chapter more as a summary of findings from a historical inquiry rather than as a prelude to a new theory of finance. Gorton, I feel, wants to do both simultaneously. The historical data, for instance, is important for him, since he knows from experience as both an academic and as somebody with stints in the public and private sector that a historical understanding is very useful indeed for policymakers. The historical data is not just of historical interest, but the platform on which policymakers analyze policy options. This may seem rather obvious to those with a variegated 'portfolio of experiences', but escape the understanding of those who have forgotten that economics is supposed to be 'worldly' in its orientation; they are, needless to say, not able to identify either the *sources of stability or the sources of instability* in the financial system (Shiller & Shiller, 2011; Shiller, 2012; Shiller, 2013). A good example of this convergence between the knowledge of economic history and the ability to design interventions during a financial crisis is the appointment of Ben Bernanke as Chairman of the Federal Reserve in 2006. Was it just a 'historical coincidence' that the person responsible for preventing the next Great Depression was also, in fact, a leading expert on the Great Depression? Would the Fed's interventions have been substantially different if Bernanke had been a technocrat with little or no knowledge of economic history? Could Bernanke have anticipated earlier in his career as an economic historian that he would attempt to save the US economy from one of the greatest financial meltdowns of all time? These questions are important because in hindsight it appears that there was a sense of 'historical necessity' in having Bernanke at the helm, but nobody – not even Bernanke – expected the economy to meltdown in 2008; even the Fed did not see it coming.

Necessity & Contingency

This then is a good example of when our notions of causality in history, our explanatory schemas turn 'contingent' events like Bernanke's appointment as Chairman of the Fed in 2006 into the more exalted order of historical necessity. It is the point at which the contingent passes into the order of historical necessity that we experience a sense of destiny: it is this form of historical explanation that creates heroes in various realms – this is 'the right person at the right place at the right time model' of historical intervention. Posterity, will no doubt, consider Bernanke as the person who was destined to save his nation's economy. This balance however between 'historical necessity' and 'contingent emergence' then is the structuring mechanism that we see at work in books like this. The main question then that readers must make up their minds on is whether financial history (given its propensity to the repetition of financial crises) is really history or theory. Unless this structural interdependence between history and theory is well-understood, the painstaking labor of American historians will not pass into the fabric of decision making by policy makers, and as Gorton reminds us in a citation from William Graham Sumner, 'the effects of the financial catastrophe…have to be learned over again apparently every ten or fifteen years, if indeed they were ever learned at all' (p.vii).

Holmesian Experiences

What then is the main source of the problem? Why are economists not able to arrive at a consensus on policy matters? Gorton argues that the problem is the political split between Main Street and Wall Street. Even the great achievements of the past like 'the National Bank Acts and federal deposit insurance' were a result of demands made by the people at large rather than 'because economists and regulators wanted it' (p. 197). This, I think, is the clincher. These achievements were contingent events -- not the unfolding of fate or destiny. What is it that would please economic or financial historians? What is the lack that Gorton identifies in US financial history? The answer, I think, is the sense of historical necessity: *there is nothing in financial history that corresponds to Manifest Destiny or American exceptionalism*. All the great achievements of financial history are attempts to fix crises – even the establishment of the US Fed in 1913-14 was but a response to the Financial Panic of 1907; none of these events were 'anticipated' and corrected before the event. If anything, it is only a severe financial crisis that provides the bipartisan impetus necessary to legislate a solution. Gorton's worry is not just related to the Holmes of Arthur Conan Doyle who ponders on the difference between 'seeing and observing', but also to the Holmes of the common law who pointed out that the 'life of the law has not been logic but experience' (Holmes, 1881, 2005). What haunts a historian then is the *lack of historical necessity* in his object of study. What else is experience in the Holmesian sense but an encounter with a formative notion of the contingent? What would, in other words, Fed policy have been if Bernanke had not been a scholar of the Great Depression?

Return of the Repressed

This incidentally is the point that James Tobin makes in an interview with Robert J. Shiller that is cited in this book (p.200). Tobin argues that macroeconomists have demonstrated a lot of indifference to catastrophes like the Great Depression, but for economists who have lived through that period it is nothing less than an 'obsession'; Bernanke shares this obsession (Bernanke, 2000; Harris, 2008; Van Overveldt, 2009). The Great Depression then, needless to say, is the historical event that cannot be 'contained' within macroeconomic theory; it is the traumatic core of economic history. It is the 'return of the repressed' that must be accommodated within structural theories and not be dismissed as an exogenous shock. There is a difference between failures within the financial system, I am tempted to add, and real exogenous shocks like a meteorite hitting the planet from outer space.

While we don't usually expect macroeconomists to dwell on the possibility of the economy being hit by passing meteorites, we expect them to be prepared for the possibility of a financial crisis given that we have already had so many in US financial history. Another important point that Gorton makes is how economic behavior is affected by the very fact that the Federal Reserve System exists: 'its existence provided a cure for panics' (p.79). The 'symbolic value' of having institutions like that (in addition to depository insurance) is bound to increase the stability of the financial system. This argument can be extended, I think, to a great deal of regulation. *What are the symbolic dimensions of regulation*? What, if anything, can governments and regulators do to deploy the symbolic dimensions of regulation more effectively as a way of shoring up the financial system? Symbolism is a potent tool to regulate the problem of economic expectations, which, incidentally, is not reducible to inflation expectations, but comprises a whole range of socio-economic phenomena that are worth studying per se (Moss, 2007). It is time then to make a choice. Gorton argues that 'we can either embrace reality – through history, institutional details, and measurement – or we can choose to ignore the lessons of the financial crisis, of our failure, and languish in irrelevancy' (p.211). Why not then make the choice of understanding the financial crisis rather than persist in misunderstanding the crisis?

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