Robert Shiller, *The Subprime Solution*

(Princeton University Press, 2008)

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Recent events have made it difficult to speak of financial 'experts' without implied quotation marks. Robert Shiller is one of the few with a right to the title, free of any irony. And that is why *The Subprime Solution* is so disappointing. Surely the man who called both the tech wreck and the housing bubble would have penetrating insights into the intricacies of the global financial crisis and its solution. Yet *The Subprime Solution* contains little more than vague platitudes and a rehash of previously published ideas.

Events have moved so fast that his short-run prescriptions are not worth dwelling on. He concentrates on the need to aid struggling homeowners by renegotiating mortgage payments. Aside from being questionable on its own terms (how are people who have walked away from no-recourse mortgages worse off than renters on similar incomes?), this emphasis means he has no specific contributions to make to today's crucial questions of financial institution recapitalisation and fiscal policy.

It is on the origins and the long-run response to the crash that Shiller has the most to say, and what he says is the hardest to swallow. He argues that the psychology of the housing bubble itself is the ultimate cause of the current problems, while low interest rates, lax regulation, and financial innovation were consequences rather than causes.

Now, this is clearly true in some sense. If there had been a more widespread recognition that the bubble was (or might be) a bubble, no doubt regulators would have been tougher and financiers would have made fewer bad bets with less leverage. But then, if enough people knew it was a bubble, it wouldn't have been a bubble in the first place.

The trouble with looking for 'ultimate causes' is that you can keep going all the way back to the Big Bang (or Genesis 1:1 if you prefer). People should instead stop at the point where they think some kind of change is possible. But the point Shiller stops at is precisely the point that seems the least amenable to alteration, if one accepts his argument that bubbles are driven by 'contagion of ideas'. How are we supposed to stop ideas from spreading? It does not help that his psychology is almost nonexistent, consisting of an infectious disease analogy, a

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reference to information cascades (which are not 'psychological' at all in the sense of contradicting standard rationality assumptions), and a collection of stories people might have told to justify rising housing prices.

Having skewered those who thought a bubble could never happen, Shiller then surprises by showing a faith in finance surpassing even theirs. Greenspan, after all, has expressed some contrition. But Shiller pins his colours to the mast of 'financial democracy', describing mathematical finance theory as a 'magnificent development'. (One wonders how he got a dust-jacket endorsement from Nassim Taleb, who gained fame by arguing precisely the opposite in *The Black Swan*). His proposal for reform consists of a new 'information infrastructure', including independent financial planning, a new consumer authority for financial products, more disclosure, and an inflation-proof unit of account; and new forms of insurance for housing and labour markets.

At this point, some loud alarm bells start ringing. These are the same ideas that Shiller has been pushing for years, through his 2003 book *The New Financial Order,* and through the 'growth companies' and 'broker-dealers' MacroMarkets LLC and MacroFinancial LLC, of which he is co-founder, chief economist and principal. Shiller's ideas may be perfectly good, but by what stretch of the imagination are they a safeguard against financial crisis? Would the facility to sell real estate short be enough to prevent another housing bubble? The losses George Soros suffered by shorting the NASDAQ in 1998 and 1999 (rather than 2000) suggest not.

Stripped of all the padding (and there is a lot of that, including a discussion of the etymology of 'bailout'), Shiller's main argument in *Subprime Solution* is that we need more financial innovation, not less. He must be one of the few men in the world who could make this argument today and not be laughed out of court. While the bubble may have had origins independent of financial innovation, it was financial innovation that fuelled its rise and allowed it to metastasise from a problem affecting one sector of the US economy (albeit a very large one) into a cancer that threatened financial institutions worldwide. Yet while he acknowledges this surface implausibility of his stance, he provides no real arguments to counter it.

Shiller deserves kudos for his amply demonstrated prescience, and he has every right to market his financial products. I just wish he had found a better way of making good than this hastily written pastiche of a book. Like short selling, for example.[2]

[2] This is not just a cheap shot. The ability to short real estate is one of Shiller's key proposals to avoid another bubble. Yet there were many ways to short the bubble at the time, through the stocks of building or financial corporations, or one of the ABX indices.