



Book Reviews

Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis

By John B. Taylor. 2009. Hoover Institution Press. Pp. 92, \$14.95 hardcover.

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In *Getting Off Track*, John B. Taylor proposes that the financial crisis was “caused, prolonged, and worsened” by past and present policies of government institutions. Professor Taylor, currently a professor of economics at Stanford University, is a highly respected economic policy expert, who previously served as Under Secretary of the U.S. Treasury for International Affairs and as a member of the President’s Council of Economic Advisors. In 2007, the National Association for Business Economics awarded him the Adam Smith Award for his life-long career as a researcher, teacher, and public servant.

According to Professor Taylor, the financial crisis was caused by the collapse of a housing bubble, which had in turn been caused by monetary policy that remained too accommodative for too long

following the 2001 economic recession. The crisis was prolonged when policymakers misdiagnosed the underlying problem as one of illiquidity rather than insolvency on the part of the banking system. And the crisis was worsened by inconsistent, *ad hoc*, and unexplained bailout decisions: Bear Stearns was rescued, as was AIG, but Lehman Brothers was not.

Taylor’s account is refreshingly short, yet it is based on a wealth of empirical data. At times, his argument may feel a bit forced. For example, the notion that it was loose monetary policy that caused the housing bubble ignores the fact that mortgage interest rates tend to be priced off long-term U.S. Treasury yields, which the Federal Reserve neither targeted nor controlled at the time, rather than off the federal funds rate, which it does.

Likewise, Taylor argues that high energy prices in recent years were caused by the inflationary effects of a low federal funds rate. But he does not mention the impact on oil prices of supply and demand factors, such as disruptions stemming from the war in Iraq, acts of terrorism, civil unrest in oil-exporting nations such as Venezuela and Nigeria, and unprecedented economic growth in emerging market countries. Here the book’s brevity may be a hindrance, and future research is needed to provide more definitive answers.

Still, Taylor’s argument contains a great deal of merit. It

is taken as gospel today that the intensification of the crisis in September 2008 was due to policymakers’ decision to allow Lehman Brothers to go bankrupt. But, Taylor shows, using a chart of the spread between various money market interest rates, most of the market turbulence did not begin until almost a week after the Lehman bankruptcy filing. By then, Fannie Mae and Freddie Mac had just been placed in federal conservatorship, and AIG had received its first bailout. By the time the turbulence reached a peak in the middle of October, Washington Mutual had been taken over by federal authorities, troubled Wachovia was to be acquired by either Citigroup or Wells Fargo, Goldman Sachs and Morgan Stanley were no longer investment banks, the Federal Reserve had announced its Commercial Paper Funding Facility and had begun paying interest on reserves to depository institutions, and the Troubled Asset Relief Program (TARP) underwent a major change *after* having been signed into law. Taylor suggests that the way in which policymakers introduced and changed the TARP decreased rather than increased public confidence, and he offers a welcome reminder that changes in market prices cannot always be attributed to a single specific cause, such as the Lehman bankruptcy.

Taylor is also right to point out the inconsistency of the various bailout decisions. Although it is beyond question

that the financial markets were disrupted by the Lehman bankruptcy, they have so far survived and will, by most accounts, eventually recover. Lehman was much larger and more diversified than was Bear Stearns. In retrospect, if Bear Stearns had been allowed to fail, the market disruption may have been less severe, and Lehman Brothers and AIG might well have begun to shore up their capital base with a far greater sense of urgency 6 months before their actual demise.

In addition, Taylor's argument is persuasive that the problem underlying the financial

system is not one of illiquidity but insolvency. The current crisis is often compared with the Great Depression. But the Great Depression was indeed due to a lack of liquidity, whereas the current crisis is not. The monetary authorities began injecting liquidity into the banking system as far back as 2007. But adding an overabundance of reserves will achieve very little if banks remain reluctant to lend for fear that counterparties will be insolvent.

In short, Taylor offers a powerful rejoinder to the all-too-pervasive notion that the financial crisis is indicative of

market failure and therefore requires a government solution. His book is written from an unabashed conservative political perspective, but it is sufficiently rich in empirical support that it deserves to be classified as scholarly rather than polemic. The book will likely stand as a valuable initial evaluation of actions taken by policymakers in addressing the crisis, one that may help us prevent making similar mistakes in the future.

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Capital Ideas Evolving

By Peter L. Bernstein. 2009.
New York: John Wiley & Sons.
pp. 304, \$29.92 hardcover.
16.95, paperback.

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In 1992, Peter Bernstein published *Capital Ideas* (New York: The Free Press), an articulate analysis of the evolution of modern portfolio theory (MPT). As his sometime coauthor, the late Robert Heilbroner, did for neoclassical economics in *The Worldly Philosophers* (1953), Bernstein told the story of the evolution of MPT and financial economics through the lives, as well as the writings, of those who formulated “capital ideas.” The result was an imminently readable treatment of the development of MPT, the capital asset

pricing model (CAPM), the efficient market hypothesis, and indexed investing. Novices in financial economics found *Capital Ideas* to be a useful introduction to the subject, and experts could not help being engaged in its stories.

The field of financial economics has changed a great deal since 1992, as has the market context in which its theories play out. Recognizing that change, Bernstein has penned a second volume, *Capital Ideas Evolving*, that is both sequel to and revision of the first. Like its predecessor, it is a valuable contribution to the history of economic thought.

Although MPT, built on the hypothesis of the ultrarational investor, was the most important development of the period covered by *Capital Ideas*, Bernstein begins his new volume with behavioral finance, the antithesis of ultrarationality. No longer merely the rejection of ration-

ality, behavioral finance has come to have a rigorous theoretical foundation of its own and a significant body of empirical evidence in its support. Bernstein traces the development of behavioral finance, beginning with Kahneman and Tversky's seminal work in the 1970s, to the more recent contributions of Richard Thaler and others. He might have traced some of the ideas of behavioral finance further into the past. Friedman and Savage observed that rising wealth leads to diminished risk aversion in their classic 1948 paper, “Utility Analysis of Choices Involving Risk;” and “Adam Smith's” (George J.W. Goodman) *The Money Game* (Random House, 1967) anticipated much of what we now know as behavioral finance.

Bernstein also reviews the work of several theorists who, although not usually considered members of the behavioral school, have made important