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Review

Reviewed Work(s): Finance and the Good Society by Robert J. Shiller

Review by: Erin Todd Bronchetti

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based stabilization plans can trigger speculative attacks or models with learning.

To conclude the book examines the theoretical literature of currency crises in extreme detail so that the reader not only can learn about the bare bones of the original models but also the bells and whistles included in the follow-up research that brings the models closer to explain empirical regularities. The book is self-contained. The mathematical appendix provides all the necessary mathematical tools that are used in the book, from solving ordinary differential and difference equations to dynamic optimization and dynamic programming. So the book is an encompassing, self-contained book on crises. Just one complaint, it does not evaluate and describe at some length the empirical evidence on crises.

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G Financial Economics

Finance and the Good Society. By Robert J. Shiller. Princeton and Oxford: Princeton University Press, 2012. Pp. xiii, 288. \$24.95. ISBN 978-0-691-15488-6.

JEL 2012-0415

Robert Shiller's *Finance and the Good Society* is a welcome contribution to the public discourse on the appropriate role for finance in our society. In the years since 2007, such discourse has been dominated by accusations of greed and fraud at nearly all major U.S. banks, calls for imprisonment of bankers, traders, and mortgage lenders allegedly responsible for the financial crisis, and outrage from both the Occupy movement and middle America at the wealth amassed by Wall Street bankers, many of whom comprise the "1 percent." But few are as qualified as Professor Shiller to answer the question of whether (or how) financial capitalism can be consistent with the goals of the good society.

This is a didactic book, organized around teaching readers the single Big Idea that to achieve the goals of the good society, the role of finance in our society should be *expanded* rather than restricted. According to Shiller, the crisis that began in 2007 was caused by the failure of existing financial institutions to assess and manage

risk, as well as a hyper-devout belief in efficient markets and the mistaken idea that home prices could never fall. Despite popular understanding, it was not caused by a sudden surge in deceptive, greed-driven behavior by bankers and traders, nor was it caused, *per se*, by a certain set of complex securitized products. In fact, the residential mortgage-backed securities implicated in the subprime crisis have great potential for increasing overall welfare, provided such securitization is accompanied by consumer protection. Therefore, in the wake of this crisis, Shiller argues that we should resist the impulse for conventionality and familiarity. Instead, our policies should foster financial innovation, reward the development of creative and complex products that serve unmet needs, and encourage market making in fundamental and important new markets. It would be a mistake to restrain finance. Rather, these times present an opportunity to reinvent financial capitalism and guide it into the future with a focus on its responsibility for the stewardship of society's assets.

In imagining how financial capitalism should evolve, Shiller appeals to two of his guiding principles, arguing that finance must be *democratized* and *humanized*. With these principles in mind, we can make the many benefits of financial innovation impactful to the broader public, meet more of society's needs, and create a "better, more prosperous, and more equitable society" (xvi).

Shiller draws on these principles to suggest what financial innovations might be a part of the good society's solution. While his proposals will be unsurprising to those who know Shiller's work, the book gets credit for bringing these ideas to a wider audience and for melding them together with a timely discussion of the proper role of finance in our society. First, the book reiterates Shiller's disappointment that modern finance has not yet evolved to help economic agents mitigate many of life's risks. Shiller has long believed that consumers should be able to purchase home equity insurance policies to protect themselves against the risk that home values in their area decline. Similarly, a fully liquid futures market in housing prices could allow individuals to hedge against sharp changes in home values. Such a market, Shiller argues, would have not

only helped lessen the fall-out from the bursting of the housing bubble, but may have helped avoid the crisis entirely, by providing real-time information about the perceived probability of a fall in home prices.

Recent history has witnessed substantial progress in extending insurance to cover more people and more risks, but Shiller suggests there is a long way to go. He envisions a world in which individuals can purchase livelihood insurance policies, which would pay out if years after investing in a certain career direction, the market for this career declined. Or they could purchase long-term catastrophe insurance, which insures “against the risk that risks will increase” (e.g., as the risk of hurricane-related damage may change unpredictably over time).

Shiller thinks along similar lines regarding macro risks, arguing that financial contracts should be written in real dollars (e.g., by indexing to consumer prices), and that debt should adjust to changes in economic circumstances. Despite the current taste for simple and conventional home mortgages, Shiller proposes more complexity in housing finance, namely, continuous-workout mortgages with terms that change in response to economic contraction or a fall in home values. Similarly, governments should borrow by issuing shares in national GDP, which Shiller dubs “trills” (one share equal to one-trillionth of total GDP). The burden of these GDP-linked bonds would automatically decrease in an economic crisis; one can imagine a far different outcome for Greece had it financed its borrowing with such flexible debt.

I was particularly interested in Shiller’s ideas about using financial innovation to address issues of equity and redistribution. For example, income tax rates could be indexed, *ex ante*, to measures of inequality, so that the system would automatically become more progressive in response to rising inequality, without any need for costly political negotiations, *ex post*, over the appropriate levels for marginal tax rates. In thinking about fairness in *intergenerational* redistribution, Shiller proposes that government pension benefits ought to adjust to reflect current taxpayers’ ability to pay (e.g., by indexing social security benefits to national GDP or other measures of economic performance).

If such innovations are needed to enhance social welfare, why hasn’t the market demanded and provided them? Shiller believes that the public impulse for conventionality and familiarity inhibits the application of financial principles and slows the pace of financial modernization. Perhaps more importantly, it slows the *democratization* of financial innovations because new ideas are often adopted only by the few who understand the new products or receive sound and sophisticated financial advice. Unfortunately, says Shiller, the impulse for conventionality and familiarity is especially powerful in the wake of a financial crisis: “People seem to want to return to their moral roots after a crisis . . . a return to old ways of doing things” (63). Along with a postcrisis desire for the traditional, Shiller fears that we suffer from a modern analogue of what Norman Angell declared “The Great Illusion,” the universal (but mistaken) idea that military conquest brings economic advantage. Today, the illusion is that those in business and finance benefit from conquest, and so have an incentive to use aggressive business tactics and “devious means to attack and subjugate, economically the majority of the population. This assumption, if left unchallenged, will create resentment toward business that will inhibit its proper functioning, thus threatening to slow the advance of the world’s prosperity in coming years” (220). Shiller blames both of these factors for the resistance he meets when proposing, for example, that we expand our array of derivatives markets and products.

In short, I appreciate Shiller’s imaginative approach to thinking about financial innovations that can be social welfare enhancing, and I find some merit in these explanations for why such innovations progress so slowly. But I am left unconvinced that the reasons Shiller provides are sufficient explanation for why the markets and products Shiller proposes have not evolved. That markets for a vast number of derivative products *have* been made successfully leads one to wonder whether the problem with products like home equity insurance and livelihood insurance is simply insufficient demand. The book, perhaps because it is intended for a wider audience, fails to make a compelling case for the market failures that justify government support of market making in these products.

The book is organized in two parts, which may remind economists of a classic macro textbook: the first part catalogues the many actors and their roles, while the second part weaves them together to create a picture of the industry and its successes and failures. While I have spent the majority of my time discussing ideas that Shiller presents in the second half of the book, I personally found the first part to be the more successful of the two. The second half of the book, "Finance and Its Discontents," has bright moments, but the discussion lacks cohesion, and the ideas lack freshness.

On the contrary, the descriptions of the financial industry's players (e.g., investment managers, traders, investment bankers, lawyers, regulators, educators) were often insightful and sometimes surprising. I particularly appreciated Shiller's emphasis on the role of lawyers and financial advisers, and the need for expanding access to expert legal and financial advice, as well as financial literacy programs, to low-income people. (The current government subsidy for legal and financial advice in the United States operates as a tax deduction for those who itemize, and therefore disproportionately benefits higher-income households.) While the cataloguing of the various players helps readers understand how the industry is woven together, at times Shiller's portrayals feel overly sunny. Regulators are "public-spirited, sincere people" (98), investment bankers are "keepers of the peace" (49), and traders are simply experts with "an intuitive appreciation of market forces" and "practical ethics" (58). At other times, the descriptions feel shallow. For instance, Shiller gives short shrift to investment bankers, both to their role in the industry and to their contribution to the financial crisis. Readers hoping to understand the industry more deeply might benefit from knowing how investment bankers interact with rating agencies and how that interaction contributes to "grade inflation" in ratings, both for securitized products and traditional debt.

As for the question of audience, Shiller began writing *Finance and the Good Society* for his students at Yale. It seems to have been written, at least in part, to convince such students that a career in finance serves a broader moral purpose than just amassing riches or enabling conspicuous consumption. During the book's writing, Shiller expanded his view to think of the general public

as his audience. For the public, the book succeeds in providing a highly credible case for viewing finance as integral to the goals of the good society, but lacks the sparkle and creativity of *Irrational Exuberance*. For professional economists who know Shiller's work, the big ideas will be familiar, but there is fun to be had in the footnotes.

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H Public Economics

America's Economic Way of War: War and the US Economy from the Spanish–American War to the Persian Gulf War. By Hugh Rockoff. New Approaches to Economic and Social History. Cambridge and New York: Cambridge University Press, 2012. Pp. xii, 357. \$26.99, paper. ISBN 978–0–521–85940–0, cloth; 978–0–521–67673–1, pbk. JEL 2012–0840

Readers know Hugh Rockoff for his writings on money, banking, and the history of economic thought, but also for his compelling *History of the American Economy* (with Gary Walton). This volume also targets a college-student readership. Accessible in its prose and scarce in footnotes—most serve for clarification and commentary—*America's Economic Way of War* surveys the wars of the twentieth century and draws on Rockoff's extensive research and long-time interest in the U.S. economy during World War II.

America's Economic Way of War dispels the notion that states of war have been aberrations from the norm in twentieth century America, or that times of war have nothing to teach us about the way economies work. It is the historian Rockoff who understands that we cannot bracket years and decades of growth, contraction, and development because they may not fit into economists' models. Indeed, if we were to set aside America's twentieth century wars—Rockoff devotes individual chapters to the conflicts from the Spanish–American to the Persian Gulf War—we would not be able to make any sense of the U.S. economy in the twentieth century at all. The questions Rockoff asks about these wars are, on the other hand, very