A Crisis of Beliefs: Investor Psychology and Financial Fragility, An Interview with Andrei Shleifer

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Overview

Over the past ten years, many books about the financial crisis have been published, including first-person accounts from Henry Paulson and Tim Geithner, post mortems by bankers and other industry participants, and analyses by a full spectrum of economists and academics. Rounding out the collection are government documents, including the 662-page *Financial Crisis Inquiry Report*.

As deep and broad as the coverage has been, one of the latest additions to the growing literature on the subject offers a new and profound perspective. In *A Crisis of Beliefs*, Andrei Shleifer, professor of economics at Harvard University, and Nicola Gennaioli, professor of finance at Bocconi University in Italy, cover themes that lie at the intersection of finance, economics, and public policy. Their work blends both philosophical observations and behavioral economics to evaluate the events and attitudes leading up to the GFC.

The book has been very well-received, with strong positive reviews in a number of major news outlets noting the unique nature of the work. In *The New York Times*, for example, Robert J. Shiller commented, "Focusing on the stock market, Professor Gennaioli and Professor Shleifer demonstrate how changeable expectations for the future really are. People tend to believe that recent changes will continue, whatever they may be, and then, when things shift, they change their expectations again."[1] This type of mental adjustment influences behavior, from individual and household decision-making to macroeconomic perspectives and public policy formulation.

Among other accolades, the *Financial Times* recently featured *A Crisis of Beliefs* on its lists for the "Best Books of the Year 2018: Economics" and the "Readers' Choice Best Books of the Year."

We had a chance to discuss the key lessons from the book with Professor Shleifer recently.

Interview

BJM: We know that there are many views on the events and aftermath of the GFC. What were some of your reasons for writing the book?

AS: The book has two principle motivations. First, we wanted to gain a better understanding of what happened in 2007 and 2008. Why was this crisis so severe and why did it lead to the Great Recession?

Second, we wanted to show that all of these ideas about credit cycles, exuberance, and neglect of risk, which are somewhat ephemeral and lie in the domain of economic historians, can also be discussed and analyzed with standard economic models.

BJM: What were some of the main misunderstandings about the crisis, in retrospect?

AS: We find two that were of central importance. One common misperception in the public's mind (and widely disseminated in the media) has been that the crisis could be attributed almost completely to moral hazard and the "too big to fail" scenario. This was based on the idea that the banks had somehow conspired to trick everybody with defective mortgages because they knew that in the end there was going to be a government bailout. That is simply not accurate.

There were many actors in the housing bubble and subsequent crisis and they were all involved at the same time: the consumers who used credit cards and the households that bought homes, the banks that lent money to those people, the financial industry that created mortgage-backed securities (MBS), and the investors that purchased them. And perhaps most importantly, the policy-makers who, as the bubble was growing, were all betting on the notion that the housing markets would continue to do well. Then, when the bubble started to deflate, they were all betting on the notion that the system was robust enough to survive. This is not to say that there wasn't bad behavior going on as well, but the situation was far more complex than that.

The second, more profound misconception is the view that the financial crisis came out of the blue, unforeseen. The book documents how the '07-'08 crisis was actually developing for a long time: it began when the housing bubble start to deflate, leading to losses on the MBS and reductions in the value of mortgages held by banks. These were leading indicators of the financial collapse to come. Given the effects rippling through the system in those early days, the full scope of the financial crisis could not have been anticipated with certainty, but it was clear early in 2008 that there was serious trouble ahead. Yet we see a serious lack of appreciation for how fragile the system really was and then there was a panic after Lehman.

BJM: This is reminiscent of the dot-com bubble, at some point the question was not if it would burst, but when.

AS: Yes, exactly. But the difference between the dot-com bubble and the financial crisis was the scope of the damage – for the dot-com bubble naturally it affected the tech sector, investors, and some companies that went out of business. However, no major financial institutions were threatened during that period. There was a mild recession in 2001 and then we emerged. In the financial crisis, those institutions were highly exposed to the consequences of the housing bubble, the subsequent panic, and the great recession. The events were not just hitting a single sector of the economy; they were tackling the entire system all at once.

BJM: What are some of your key takeaways for economists, policy makers, and investors?

AS: For economists, we advise: "Yes, you can." Which is to say that you can think about the problems of financial stability while using the tools of standard macroeconomics.

For policymakers, we show that it is best to act as early and as aggressively as possible. The idea that you should not do anything until a Lehman-type event happens is incorrect. As we see, they could have started preparing in early 2007 – by telling the banks not to pay dividends, compelling them to raise equity and shore up their balance sheets, for example. All of the policies would have been effective and so the issue becomes one of planning and action before a crisis, not during and afterwards.

For investors, we would say that if it looks like a bubble and feels like a bubble, it probably is a bubble. Deflation can come slowly, but if valuations seem to be unrelated to fundamentals, then it is probably a good idea to start getting out.

BJM: One of the common themes for investors comes back to diversification and these days there are more vehicles – from traditional alternatives to newer forms accessible through '40 Act funds and UCITS. What would you say to CAIA members who are evaluating the options for their clients?

AS: As we now know, during a crisis many of these assets become more highly correlated than they are under normal circumstances. So, the elements that might typically be diversifying – European debt, emerging market debt, private equity – may not be that helpful after all.

However, this does not mean that one should sell everything in a panic. Some of the most sophisticated investors, including university endowments, chose to liquidate after Lehman in late 2008 and early 2009. That turned out to be a very costly decision for those institutions. So, we would say, "Observe carefully and act in advance, but not in a hurry."

BJM: Very good – thank you for your time.

This book covers a range of errors in beliefs in a compelling technical and analytical framework, so there is plenty of food for thought on these and many other issues related to the GFC. As economic historian and UCal-Berkeley professor, J. Bradford de Long noted on his blog, "For a decade now, people have been looking for a silver lining to the disasters of 2008-2018, hoping that this period will bring about a more productive integration of finance, behavioral economics, and macroeconomic orthodoxy. So far, they have been searching in vain. But with the publication of *A Crisis of Beliefs*, there is hope yet."[2] We would agree – there is always hope!

A Crisis of Beliefs: Investor Psychology and Financial Fragility, by Nicola Gennaioli and Andrei Shleifer on Princeton University Press https://press.princeton.edu/titles/14150.html and on Amazon https://www.amazon.com/Crisis-Beliefs-Psychology-Financial-Fragility/dp/0691182507.

Endnote

1. "Why Our Beliefs Don't Predict Much About the Economy," by Robert J. Shiller, *The New York Times*, Economic View, October 12, 2018. https://www.nytimes.com/2018/10/12/business/why-our-beliefs-dont-predict-much-about-the-economy.html.
2. "Self-Fulfilling Financial Crises," by J. Bradford DeLong, via *Project Syndicate*, October 15, 2018. https://www.project-syndicate.org/commentary/crisis-of-beliefs-and-the-2008-crash-by-j--bradford-delong-2018-10.

Author Bios

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Andrei Shleifer is John L. Loeb Professor of Economics at Harvard University. He holds an undergraduate degree from Harvard and a Ph.D. from MIT. Before coming to Harvard in 1991, he has taught at Princeton and the Chicago Business School. Professor Shleifer has worked in the areas of comparative corporate governance, law and finance, behavioral finance, as well as institutional economics. He has published seven books, including *The Grabbing Hand: Government Pathologies and Their Cures* (with Robert Vishny), *Inefficient Markets: An Introduction to Behavioral Finance*, and *A Crisis of Beliefs: Investor Psychology and Financial Fragility* (with Nicola Gennaioli), as well as over a hundred articles.

Professor Shleifer is an Editor of the *Quarterly Journal of Economics,* and a fellow of the Econometric Society, the American Academy of Arts and Sciences, and the American Finance Association. In 1999, he won the John Bates Clark medal of the American Economic Association. According to RePEc, he is the most cited economist in the world.

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Barbara J. Mack is founder and president of the consulting firm Pingry Hill Enterprises, Inc. For over fifteen years, she has worked as a consultant, editor, writer, and researcher on projects involving alternative investments, international economics, and technological innovation. Her previous work experience includes appointments as a case writer at Harvard Business School and a research affiliate at the Computer Science and Artificial Intelligence Lab (CSAIL) at MIT.

Barbara has a Masters degree from Harvard University's Kennedy School of Government, with a focus on law and policy in the European Union. She also has a Bachelor of Arts from Tufts University, where she focused on English Literature, Anthropology, and Fine Art.