Our Epistemological Depression

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Major recessions are characterized by something novel. Opacity and pseudo-objectivity created the crisis today.

The history of socialism is the history of failure—and so is the history of capitalism, but in a different sense. For the history of socialism is one of fundamental failure, a failure to provide incentives and an inability to coordinate information about supply and effective demand. The history of capitalism, by contrast, is the history of dialectical failure: it is a history of the creation of new institutions and practices that may be successful, even transformative for a while, but which eventually prove dysfunctional, either because their intrinsic weaknesses become more evident over time or because of a change in external circumstances. Historically, these institutional failures have led to two reactions. They lead to governmental attempts to reform corporate and financial institutions, through changes in law and regulation (such as limited liability laws, creation of the FDIC, the SEC, etc.). They also lead market institutions to reform themselves, as investors and managers learn what forms of organization and which practices are dysfunctional. The history of capitalism, then, is the history of success through dialectical failure.

History rarely repeats itself. There are some standard patterns in economic recessions, but major recessions are characterized by something novel. If only this were not the case: economists have devoted a great deal of attention to learning the lessons of the Great Depression that began in 1929, not least Ben Bernanke. As a result, we are unlikely to make the errors of monetary policy made by the Fed in that era (of tightening money when it should have been loosened); or the errors of fiscal policy made by the Treasury (such as raising taxes when they should have been lowered); or the errors of ideological tone made during the 1930s, when anticapitalist rhetoric frightened many potential investors from making new investments. In all of these respects, we have learned from the past.

Unfortunately, initial conditions are too different from case to case to simply apply some historical template that would permit us to fully understand what is currently happening, let alone how to deal with it. Instead of explaining why this recession (or depression) is just like the others, we should attend to what is new and especially problematic about the current downturn and why it may not respond to policies modeled on avoiding the errors of the past.

What is old and what is new in the current economic downturn? Major recessions typically begin with a rapid change of prices in the market for some asset or commodity; that price decline then affects financial institutions (banks), leading to a decline in the availability of credit, and then to a
decline in commercial activity. Usually, then, localized crises in capitalist societies are reflected in the financial sector. When the crisis reaches the financial sector, it becomes a more general crisis.

This time, too, there is an underlying commodity bubble, namely in housing. But it has had much wider ramifications, because financial institutions have become interconnected in two unprecedented ways. First, once distinct financial services became interconnected: banking, credit, insurance, and the trading of derivatives have become interlinked because they are conducted by the same companies. Second, financial institutions are more connected across national borders, so that there are entities across the globe that invested in toxic American-made instruments and are suffering as a result (including municipalities in Norway that invested tax revenues in American collateralized debt obligations, now worth 15 percent of their face value).

What we have is not so much the crisis of some underlying commodity that gets reflected in the financial system, as a crisis caused within the financial system itself. The most important bubble of the last decade or so was not of the housing sector, but of the financial sector, a bubble reflected by the 20 percent of S & P 500 profits that were made in the financial sector.

Some of the causes of our contemporary crisis are well known by now. There were governmental errors: monetary policy that was too loose; government monitoring agencies that were too lax; and government policies specifically intended to encourage home ownership among African-Americans and Hispanics that had the unintended but quite anticipatable effect of extending mortgages to those who lacked the ability to repay them. There were perverse alignments of market incentives, incentives that put personal interests at odds with corporate interests, and corporate interests at odds with the public interest. There were principal-agent problem within firms, where traders were remunerated with bonuses for selling collateralized debt obligations without regard to the long-run viability of the underlying assets. Rating agencies were corrupted because they were paid by the sellers of the goods they rated, offering unreliable evaluations that redounded against the purchasers of mortgage-backed securities. Large profits were made by companies that packaged and sold mortgages and mortgage-backed securities without needing to be concerned with their ultimate viability. It turns out that intermediation of risk reduces the incentives for adequate risk management: so long as risk is intermediated, from a mortgage loan broker to a commercial bank to an investment bank to an investor, there is really no incentive, at each stage of the game, to have adequate risk-managing policies in place.

These factors have received a good deal of attention. But they are not the whole story, and certainly not the most original part of the predicament. What seems most novel is the role of opacity and pseudo-objectivity. This may be our first epistemologically-driven depression. (Epistemology is the branch of philosophy that deals with the nature and limits of knowledge, with how we know what we think we know.) That is, a large role was played by the failure of the private and corporate actors to understand what they were doing. Most heads of ailing or deceased financial institutions did not comprehend the degree of risk and exposure entailed by the dealings of their underlings—and many investors, including municipalities and pension funds, bought financial instruments without understanding the risks involved. We should keep this in mind when we chastise government agencies such as the SEC for failing to monitor what was going on. If the leading executives of financial firms failed to understand what was taking place, how could we expect government regulators to do so? The financial system created a fog so thick that even its captains could not navigate it.

Recognizing the novel element of the present crisis means that getting out of it will require more than wise monetary and fiscal policy. Getting us out of the current mess requires calling into question several cultural patterns that have driven our corporate economy in recent decades.
These are belief in the virtues of diversification and complexity, which are both supposed to reduce risk, and in the virtue of accountability, which is understood as rewarding performance based on ostensible measures of objectivity. Each of these has turned out to have unintended and unanticipated negative consequences. The purported virtues have mutated into vices.

The diversification of investment, which was intended to reduce risk to institutional investors, ended up spreading risk more widely, as investors across the country and around the world found themselves holding mortgage-backed American securities of declining and indeterminate value. There was a belief in the financial sector that diversification of assets was a substitute for due diligence on each asset, so that if one bundled enough assets together, one didn’t have to know much about the assets themselves. The creation of securities based on a pool of diverse assets (mortgage loans, student loans, credit card receivables, etc.) meant that when markets declined radically, it became impossible to determine an accurate price for the security.

There was also the fallacy of diversification of activities within the firm. This was predicated on the belief that the more areas you are financially involved in, the more protected you are from loss in any one area. But the unintended consequence of this is that the more areas you are involved in, the less you know about them, and the more subject you are to unexpected and unanticipated shocks, especially when the assets decline in tandem.

The diversification of financial firms, which was supposed to create efficiencies and synergies, ended up spreading contagion, as investment banks and other financial institutions such as AIG (once a successful insurance company) were brought down by divisions specializing in real estate or in derivatives.

The complexity of newly created financial instruments, which were supposed to use mathematical sophistication to diminish risk, ended up creating opacity—an inability of any but a few analysts to get a clear sense of what was happening. And the creation of arcane financial instruments made effective supervision virtually impossible, both by superiors in the firm, and by outside regulators.

The cult of “accountability” was related to diversification. As companies grew larger and more diverse in their holdings, new layers of management were needed to supervise and coordinate their disparate units. From the point of view of top management, the diversity of operations means that executives were managing assets and services with which they have little familiarity. This has led to the spread of pseudo-objectivity: the search for standardized measures of achievement across large and disparate organizations. Its implicit premises were these: that information which is numerically measurable is the only sort of knowledge necessary; that numerical data can substitute for other forms of inquiry; and that numerical acumen can substitute for practical knowledge about the underlying assets and services.

A good deal of our current economic travails can be traced to this increasing valuation of purportedly objective criteria, so denoted because they can be expressed and manipulated in mathematical form by people who may be skilled at such manipulation but who lack “concrete” knowledge or experience of the things being made or traded. As Niall Ferguson has put it, “Those whom the gods want to destroy they first teach math.” The paradigm—and the precursor of our current crisis—was the rise and fall of Long Term Capital Management, founded by two of the fathers of quantitative options financing, Myron Scholes and Robert C. Merton. Knowing a great deal of math, but not very much history, they developed trading models that radically underestimated the risk entailed in their financial speculation, leading to a dramatic collapse of the company in the summer of 1998. But the phenomenon is more widespread. Attaching a number creates a belief that the information is more solid than is actually the case. That is what I mean by “pseudo-objectivity.” In each case, it is a response to what (to recoin a phrase) one might call...
alienation from the means of production, the attempt to substitute abstract and quantitative knowledge for concrete and qualitative knowledge.

The cult of “accountability” was linked to key innovations that turned out to have unanticipated undersides. One was the shibboleth of linking pay to performance, which put a premium on schemes that purported to measure performance. This tended to produce “hard” numbers that seemed reliable but were not. It created tremendous incentives for CEOs, executives, and traders to devote their creative energies to gaming the metrics, i.e. into coming up with schemes that purported to demonstrate productivity or profit by massaging the data, or by underinvesting in maintenance and human capital formation to boost quarterly earnings or their equivalents.

Two milestones in the process of creating the fog of finance were the transformation of Wall Street investment banks from private partnerships to publicly traded corporations (beginning with Salomon Brothers in 1986), and the repeal of the Glass-Steagall Act of 1933 through the Gramm-Leach-Bliley Act of 1999. The former created tremendous incentives for risk-taking, since the firms no longer invested using the money of their top executives, who instead were remunerated based in large part on the amount of business the firm conducted, creating incentives to increase business by producing ever more complex and opaque financial instruments, such as collateralized debt obligations, swaps, etc. Then along came Gramm-Leach-Bliley, which opened the door to unlimited contagion, so that when one financial sector turned downward, it took the rest with it.

Looking ahead, the sort of government regulation and private re-organization that will be most beneficial will focus on these epistemological problems. Some of this goes under the rubric of transparency: making the asset holdings of financial institutions more publicly visible in order to reduce the problem of counterparty risk. Equally desirable would be transparency through the reduction of complexity, which includes avoiding intra-institutional contagion through greater limits on the ability of financial institutions to engage in an open-ended variety of financial activities. It means, in short, the reformulation of something like the Glass-Steagall Act, which would separate savings banks, investment banks, insurance and brokerage from one another.

Over and above government action, private individuals and firms should make decisions with these epistemological considerations in mind. That would mean avoiding firms that are “too complex to manage” in Amar Bhidé’s memorable phrase. Companies should not expand beyond the ability of top management to comprehend the firm’s actual activities. That will mean smaller and less diversified firms. Investors may want to ask the question: is this firm so big, or engaged in such diverse activities that its management doesn’t understand the activities in which it is involved? (And by understand, I don’t mean simply the ability to read a current balance sheet, but rather to understand the underlying dynamics of the products or services being provided.) If not, decide to invest elsewhere.

This message has not yet taken hold among public policy makers. There is much talk about monetary policy and fiscal stimulus. But without financial institutions that people have faith in, a fiscal stimulus is unlikely to have much of a multiplier effect. It is widely assumed that people will have faith in financial institutions if the Treasury injects capital into them. But the problem is not just that major financial institutions are short on operating capital: it is that recent experience seems to show that they are incapable of prudently managing the capital they have. In short, economic actors believe that other economic actors don’t know what they’re doing. Nor is the problem merely one of isolating “bad assets”—it is of a system that creates bad assets because of misaligned incentives and the fog created by opacity and pseudo-objectivity.

Confidence cannot just be conjured out of air. Nor can it be created with injections of capital or
fiscal stimulus. It will be rebuilt to the extent that financial institutions take actions that lead us to believe that they know what they are doing. And they are more likely to know what they are doing if they are smaller, less diversified, and less engaged with financial instruments that are too clever by half.

Some recent policies seem likely to exacerbate the problems I’ve outlined. Take the Treasury’s encouragement of institutional consolidation through amalgamation. Bank of America was encouraged to take over Merrill Lynch; and JPMorgan Chase took over Bear Stearns, and then bought the assets of Washington Mutual. Whatever the purported advantages of these takeovers, the creation of ever larger and more diversified companies makes it more likely that these firms will be plagued by the epistemological problems noted above. The Treasury has created more firms that can’t really be understood (or whose riskiness can’t be assessed)—not by their managers, not by government regulators, and not by investors.

To speak of a crisis of financial epistemology may sound abstract, but it has had very concrete and disastrous consequences. Understanding this underrated aspect of our current crisis is a prerequisite for getting us out of the hole we’ve dug ourselves into.

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Editor’s note: Amar Bhide has asked that it be noted that some of the ideas in this essay draw upon his articles, “An accident waiting to happen,” which appeared on his website, and "Insiders and Outsiders," which appeared on Forbes.com.

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