Slate

What Caused the Economic Crisis?

The 15 best explanations for the Great Recession.

By Jacob Weisberg

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As the financial crisis of 2008-09 draws to a close, narratives of the meltdown are flooding bookstores, think tanks are cranking out white papers, and four different congressional committees, along with the official Financial Crisis Inquiry Commission, are investigating what went wrong. Well they might, as the most basic question about the meltdown remains unsettled: Why did it happen?

The only near consensus is on the question of what triggered the not-quite-a-depression. In 2007, the housing bubble burst, leading to a high rate of defaults on subprime mortgages. Exposure to bad mortgages doomed Bear Stearns in March 2008, then led to a banking crisis that fall. A global recession became inevitable once the government decided not to rescue Lehman Bros. from default in September 2008. Lehman's was the biggest bankruptcy in history, and it led promptly to a powerful economic contraction. Somewhere around here, agreement ends.

There are no strong candidates for what logicians call a *sufficient* condition—a single factor that would have caused the crisis in the absence of any others. There are, however, a number of plausible *necessary* conditions—factors without which the crisis would not have occurred. Most analysts find former Fed Chairman Alan Greenspan at fault, though for a variety of reasons. Conservative economists—ever worried about inflation—tend to fault Greenspan for keeping interest rates too low between 2003 and 2005 as the real estate and credit bubbles inflated. This is the view, for instance, of Stanford economist and former Reagan adviser John Taylor, who argues that the Fed's easy money policies spurred a frenzy of irresponsible borrowing on the part of banks and consumers alike.

Liberal analysts, by contrast, are more likely to focus on the way Greenspan's aversion to regulation transformed pellmell innovation in financial products and excessive bank leverage into lethal phenomena. The pithiest explanation I've seen comes from *New York Times* columnist and Nobel Laureate Paul Krugman, who noted in one interview: "Regulation didn't keep up with the system." In this view, the emergence of an unsupervised market in more and more exotic derivatives—credit-default swaps (CDSs), collateralized debt obligations (CDOs), CDSs *on* CDOs (the esoteric instruments that wrecked AIG)—allowed heedless financial institutions to put the w hole financial system at risk. "Financial innovation + inadequate regulation = recipe for disaster is also the favored explanation of Greenspan's successor, Ben Bernanke, who downplays low interest rates as a cause (perhaps because he supported them at the time) and attributes the crisis to regulatory failure.

A bit farther down on the list are various contributing factors, which didn't fundamentally cause the crisis but either enabled it or made it worse than it otherwise might have been. These include: global savings imbalances, which put upward pressure on U.S. asset prices and downward pressure on interest rates during the bubble years; conflicts of interest and massive misjudgments on the part of credit rating agencies Moody's and Standard and Poor's about the risks of mortgage-backed securities; the lack of transparency about the risks borne by banks, which used off-balance-sheet entities known as SIVs to hide what they were doing; excessive reliance on mathematical models like the VAR and the dread Gaussian copula function, which led to the underpricing of unpredictable forms of risk; a flawed model of executive compensation and implicit too-big-to-fail guarantees that encouraged traders and executives at financial firms to take on excessive risk; and the non-confidence-inspiring quality of former Treasury Secretary Hank Paulson's initial responses to the crisis.

Other analysts look to the underlying mindset that supported the meltdown. People like to say that the crisis was caused by shortsightedness, stupidity, and greed. But those are weak explanations, unless you think human

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nature somehow changed in the final decades of the 20th century to make people greedier or more foolish than they were previously. This isn't impossible, but it's hard to support. A subtler psychological argument is that the economy fell prey to recurring delusions about risk and bubbles, which economists Carmen Reinhart and Kenneth Rogoff describe in their book *This Time Is Different*. In another new book, *How Markets Fail*, *New Yorker* writer John Cassidy focuses on the fallacies of free-market fundamentalists (Greenspan again). Still other writers, like Nobel Prize winner Joseph Stiglitz in his new book, *Freefall*, point to the way globalization spread the toxicity from one country's mortgage market to the rest of the world. Not all such explanations fall according to ideological expectations. The polymathic conservative jurist Richard Posner, argues in his book*A Failure of Capitalism* that the free market itself is to blame for the recent troubles. What these "root causes" explanations have in common is that they don't lend themselves to practical solutions.

This survey leaves out variousideological and esoteric ideas about the cause of the crisis. Their reasons have shifted, but most libertarians and *Wall Street Journal* editorial page contributors continue to insist that government caused the whole ordeal. In *I.O.U.,* the only truly entertaining book of the many I've now read or browsed on the subject, British writer John Lanchester tosses out the theory that after the West won the Cold W ar, capitalism could go naked, because governments no longer had to worry about winning converts away from Communism. This is a fascinating idea about the crisis with no evidence whatsoever to support it.

Historians are still debating what caused the Great Depression, so it's not likely t his argument will be settled anytime soon. But if we haven't at least learned that our financial markets need stronger r egulatory supervision and better controls to prevent bad bets by big firms from going viral, we'll be back in the same place before you can say 30 times leverage.

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