

Our Epistemological Depression

[By Jerry Z. Muller](#)

The American – The Journal of the American Enterprise Institute,

The history of socialism is the history of failure—and so is the history of capitalism, but in a different sense. Failure to provide incentives and an inability to coordinate information about supply and effective demand is a *dialectical* failure: it is a history of the creation of new institutions and practices that may be successful, even if dysfunctional, either because their intrinsic weaknesses become more evident over time or because of a change in circumstances. Capitalist failures have led to two reactions. They lead to governmental attempts to reform corporate and financial institutions (through liability laws, creation of the FDIC, the SEC, etc.). They also lead market institutions to reform themselves, to discard which practices are dysfunctional. The history of capitalism, then, is the history of success through dialectic.

History rarely repeats itself. There are some standard patterns in economic recessions, but major recessions are unique cases: economists have devoted a great deal of attention to learning the lessons of the Great Depression that 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); the Treasury (such as raising taxes when they should have been lowered); or the errors of ideological tone that drove away many potential investors from making new investments. In all of these respects, we have learned from the past.

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Unfortunately, initial conditions are too different from case to case to simply apply some historical template. 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 sharp price decline that then affects financial institutions (banks), leading to a decline in the availability of credit. In capitalist societies, localized crises are *reflected* in the financial sector. When the crisis reaches the financial sector, it becomes a systemic crisis.

This time, too, there is an underlying commodity bubble, namely in housing. But it has had much wider ramifications than in the past because it is interconnected in two unprecedented ways. First, once distinct financial services became interconnected: banks, insurance companies, and investment firms have become interlinked because they are conducted by the same companies. Second, financial institutions are now interconnected across the globe that invested in toxic American-made instruments and are suffering as a result (including collateralized debt obligations, now worth 15 percent of their face value).

The financial system created a fog so thick that even its captains could not navigate it.

What we have is not so much the crisis of some underlying commodity that gets *reflected* in the financial sector, but of the financial sector itself. The most important bubble of the last decade or so was not of the housing sector, but of the financial sector, a bubble made in the financial sector.

Some of the causes of our contemporary crisis are well known by now. There were governmental errors: regulatory agencies that were too lax; and government policies specifically intended to encourage home ownership and the quite anticipatable effect of extending mortgages to those who lacked the ability to repay them. There were personal interests at odds with corporate interests, and corporate interests at odds with the public interest. Executives were remunerated with bonuses for selling collateralized debt obligations without regard to the long-run viability of the assets because they were paid by the sellers of the goods they rated, offering unreliable evaluations that redounded to their profits were made by companies that packaged and sold mortgages and mortgage-backed securities without regard to the long-run viability of the assets.

out that intermediation of risk reduces the incentives for adequate risk management: so long as risk is inter- an investment bank to an investor, there is really no incentive, at each stage of the game, to have adequate

These factors have received a good deal of attention. But they are not the whole story, and certainly not the role of *opacity* and *pseudo-objectivity*. This may be our first epistemologically-driven depression. (Epi- and limits of knowledge, with how we know what we think we know.) That is, a large role was played by *they were doing*. Most heads of ailing or deceased financial institutions did not comprehend the degree of and many investors, including municipalities and pension funds, bought financial instruments without und- we chastise government agencies such as the SEC for failing to monitor what was going on. If the leading place, how could we expect government regulators to do so? The financial system created a fog so thick th

Diversification and complexity, which are both supposed to reduce risk, turned out to have unintended and mutated into vices.

Recognizing the novel element of the present crisis means that getting out of it will require more than wise requires calling into question several cultural patterns that have driven our corporate economy in recent de- complexity, which are both supposed to reduce risk, and in the virtue of accountability, which is understood objectivity. Each of these has turned out to have unintended and unanticipated negative consequences. The

The diversification of investment, which was intended to reduce risk to institutional investors, ended up sp- around the world found themselves holding mortgage-backed American securities of declining and indeter- diversification of assets was a substitute for due diligence on each asset, so that if one bundled enough ass- themselves. The creation of securities based on a pool of diverse assets (mortgage loans, student loans, cre- 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- protected you are from loss in any one area. But the unintended consequence of this is that the more areas- 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 s- institutions such as AIG (once a successful insurance company) were brought down by divisions specializi-

The complexity of newly created financial instruments, which were supposed to use mathematical sophisti- any but a few analysts to get a clear sense of what was happening. And the creation of arcane financial ins- superiors in the firm, and by outside regulators.

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The cult of "accountability" was related to diversification. As companies grew larger and more diverse in t- supervise and coordinate their disparate units. From the point of view of top management, the diversity of services with which they have little familiarity. This has led to the spread of pseudo-objectivity: the search- disparate organizations. Its implicit premises were these: that information which is numerically measurable- substitute for other forms of inquiry; and that numerical acumen can substitute for practical knowledge abo-

A good deal of our current economic travails can be traced to this increasing valuation of purportedly obje- manipulated in mathematical form by people who may be skilled at such manipulation but who lack "conc- traded. As Niall Ferguson has put it, "Those whom the gods want to destroy they first teach math." The pa- fall of Long Term Capital Management, founded by two of the fathers of quantitative options financing, M- math, but not very much history, they developed trading models that radically underestimated the risk enta- of the company in the summer of 1998. But the phenomenon is more widespread. Attaching a number crea-

case. That is what I mean by “pseudo-objectivity.” In each case, it is a response to what (to recoin a phrase) attempt to substitute abstract and quantitative knowledge for concrete and qualitative knowledge.

The shibboleth of linking pay to performance created tremendous incentives for CEOs, executives, and traders.

The cult of “accountability” was linked to key innovations that turned out to have unanticipated undersides. It put a premium on schemes that purported to *measure* performance. This tended to produce “hard” number incentives for CEOs, executives, and traders to devote their creative energies to gaming the metrics, i.e. in productivity or profit by massaging the data, or by underinvesting in maintenance and human capital formation.

Two milestones in the process of creating the fog of finance were the transformation of Wall Street investment corporations (beginning with Salomon Brothers in 1986), and the repeal of the Glass-Steagall Act of 1933. The repeal created tremendous incentives for risk-taking, since the firms no longer invested using the money of their customers on the amount of business the firm conducted, creating incentives to increase business by producing ever more collateralized debt obligations, swaps, etc. Then along came Gramm-Leach-Bliley, which opened the door downward, it took the rest with it.

Looking ahead, the sort of government regulation and private re-organization that will be most beneficial will be under the rubric of transparency: making the asset holdings of financial institutions more publicly visible in a way that is desirable would be transparency through the reduction of complexity, which includes avoiding intra-institutional activities. It means, in short, the reformulation of 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 constraints in mind: firms that are “too complex to manage” in Amar Bhidé’s memorable phrase. Companies should not expand into activities that are not understood. That will mean smaller and less diversified firms. Investors may want to ask the question: does management understand the activities in which it is involved? (And by understand, I don’t mean simply understand the underlying dynamics of the products or services being provided.) If not, decide to invest elsewhere.

Without financial institutions that people have faith in, a fiscal stimulus is unlikely to have much of a multiplier effect.

This message has not yet taken hold among public policy makers. There is much talk about monetary policy, but without people have faith in, a fiscal stimulus is unlikely to have much of a multiplier effect. It is widely assumed that injecting capital into them. But the problem is not just that major financial institutions are short on operating capital, but are incapable of prudently managing the capital they have. In short, economic actors believe that other economic actors are merely one of isolating “bad assets”—it is of a system that *creates* bad assets because of misaligned incentives.

Confidence cannot just be conjured out of air. Nor can it be created with injections of capital or fiscal stimulus. It is actions that lead us to believe that they know what they are doing. And they are more likely to know what they are doing when 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 America was encouraged to take over Merrill Lynch; and JPMorgan Chase took over Bear Stearns, and the purported advantages of these takeovers, the creation of ever larger and more diversified companies makes the epistemological problems noted above. The Treasury has created more firms that can’t really be understood 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. A 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 art website, and “[Insiders and Outsiders](#),” which appeared on Forbes.com