Finance and Philosophy: Why We’re Always Surprised

Alex J. Pollock

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Former Federal Reserve Chairman Paul Volcker famously said that, “about every 10 years, we have the greatest crisis in 50 years.” Now comes Alex Pollock to document both why financial crises happen so frequently and why we fail to anticipate them. This handy book offers a Cook’s Tour of why financial systems go into crisis, the inability of economists and their economic models to predict crises, the misplaced efforts of financial regulators to predict and address them, and forms of over-indebtedness such as the repeated collapse of the housing market and financial institutions that invest in home mortgages. Mr. Pollock explains these events with reference to financial misfortunes over the centuries and common reasons for financial failure and crises. He does this with humor and clarity.

This is a book that every banker and every financial regulator should read, preferably early in his or her career. In contrast to many books about the financial system, this is not a technical treatise; rather it provides the reader an historical and financial, and indeed philosophical, context that seasoned bankers gain over many years, sometimes from painful experience.

Mr. Pollock is the ideal person to share such experience, with a career that bridges the financial and policy worlds. His 35-year career in banking included serving as CEO of the Federal Home Loan Bank of Chicago and before that as one of the youngest Senior Vice Presidents of Continental Illinois. On the policy side he was a resident fellow at the American Enterprise Institute for 11 years before becoming Distinguished Senior Fellow at the R Street Institute, a Washington, DC think tank.

Each of the book’s 18 chapters offers insight about different aspects of the financial system and its cycles. The chapters divide nicely into three parts: (1) warnings against hubris and false optimism about the stability of the financial system; (2) application of these lessons to a range of financial issues; and (3) recognition that risk-taking has been essential to the remarkable rate of

economic growth of the United States. The final chapters offer recommendations about the useful role of government and virtues that people should practice in finance when dealing with other people’s money. The reader should be forewarned: the first few chapters paint a sobering picture of the inherent instability of financial systems. Only at the end does gloom lift to reveal insightful recommendations that take account both of the costs of financial crises and also the benefits of the remarkable rate of growth that can result from financial boom and bust cycles.

The first section, Chapters 1-7, show the uncertainties that inevitably result from a financial system that is “densely recursive, self-reflective, [and] complex.” Chapter 1 shows how actions of each participant in the system — whether central banker, banker, financial regulator, or borrower — affect the actions of every other player, and make the system unable to reach a stable equilibrium. Pollock warns that government regulators and central bankers too are merely parts of the larger financial system that they are supposed to oversee: “They are only some of many agents, themselves caught up in the confusing, self-referencing interactions, and are themselves unable to know what the results of their actions, however well intentioned, will be.”

Chapter 2 expands on the implications of fundamental uncertainty for the continuing occurrence of costly financial crises. Here, the insight of seasoned finance professor George Kaufman applies: “Everybody knows George Santayana’s dictum that those who fail to study the past are condemned to repeat it. When it comes to finance, those who do study the past are condemned to recognize patterns they see developing, and then repeat them anyway!”

Chapter 3 turns to the recurring problem of financial bubbles and the disappearance of liquidity when the bubble bursts. Pollock points out that a “price,” something that appears solid and tangible, in fact reflects expectations rather than a fixed reality. As the market heats up even the most intelligent people — Sir Isaac Newton in the South Sea Bubble, among several whom Mr. Pollock mentions — rush to make quick earnings. As market prices overshoot their sustainable value, the bubble bursts and investors find themselves sadder but wiser, at least for a time.

Not only investors get caught in the collapse. As market prices go up, lenders too find themselves swept up in the general enthusiasm (“irrational exuberance”) and increasingly “lend long and borrow short.” The savings and loan debacle and the Financial Crisis, for instance, showed lenders using short-term money to fund long-term mortgages. In the Financial Crisis, after prices dropped and losses and panic occurred, lenders found that they could not roll over their short-term debt: liquidity dried up. In the case of the savings and loans, government deposit insurance allowed lenders to keep borrowing so that they could greatly compound the ultimate losses as they tried to gamble for resurrection.

Chapter 4 turns to the problem of leverage and the eagerness of lenders to expand their borrowing and minimize the amount of equity capital at stake in their operations. In good times this works well; when the bubble bursts, highly leveraged lenders fail much more rapidly than their more prudent and better-capitalized competitors. Here, JPMorganChase (JPMC) and CEO Jamie Dimon’s “Fortress Balance Sheet” come to mind. In the Financial Crisis, a well-capitalized JPMC had financial resources available to purchase failed Bear Stearns and the assets of failed Washington Mutual at bargain prices.

Having demonstrated the ephemeral nature of concepts of financial stability and prices, Mr. Pollock turns in chapter 5 to economists, especially at the Federal Reserve, and their poor record in predicting financial crises. Here again, the problem lies in the self-reflexive nature of economic forecasts. Thus, says Pollock, “Economists can and do write mathematical formulas, but these formulas have never been, are not, and cannot be reliably predictive laws.”

Chapter 6 provides a nice overview of data compiled by Carmen Reinhart and Kenneth Rogoff in their excellent analysis, This Time is Different: 800 Years of Financial Folly. Pollock summarizes the evidence: in 130 countries in the 100 years of the 20th century, financial systems experienced crises 263 times, or 2.6 times per year. Given this record, Pollock’s book becomes especially important: bankers and financial regulators need to understand that — even though their worlds seem stable and predictable — major bad events will happen more often than they expect. Indeed, one lesson of the Financial Crisis is that financial firms that resisted some of the popular follies that Pollock recounts were able to navigate the crisis and even improve their positions as less prudent competitors failed.

Chapter 7 shows a dilemma of government that stems from the fundamental instability of the financial system. Government often is tempted to try to save money by using financial institutions to accomplish social goals. Think, for instance, of Fannie Mae and Freddie Mac, the two massive and inherently unstable financial mortgage lenders that gained market share — before they failed in 2008 — from statutory advantages that allowed them to maintain much higher leverage than their competitors, among other benefits, and thereby reduced mortgage interest rates by a small amount. When the two enterprises came under stress, those policies and especially their high leverage, led them to collapse much faster than they otherwise would have. The failure of some parts of government to learn this lesson even after the Crisis is seen in recent encouragement of the regulator of the two fallen enterprises for them to offer low-downpayment mortgages that help lower income people better to afford home purchases, but that also begin to replicate the pre-crisis tendency of the two companies to increase their credit risk beyond reasonable proportions. Once such policies and institutions fail, Pollock observes, taxpayers are left to pay for bailing them out.

The second section expands the lessons about imprudence and its consequences. Chapters 8-14 survey the savings and loan and sovereign lending debacles of the 1980s, the Federal Reserve and the impact of today’s monetary policy on those who save rather than spend their available funds, the susceptibility of accounting conventions to uncertainties of price and financial cycles, excessive national government indebtedness and financial failures, municipal government financial vulnerabilities, and burgeoning deficits caused by underfunded pension and social insurance programs. Again, there is much to be learned. One wishes only that Mr. Pollock had devoted an additional chapter to a factor closely linked to the likelihood and severity of financial crises: the ability of politically powerful financial institutions to lobby to weaken capital standards and other protections that might increase resilience of the financial system.

It is in the third and final section that Mr. Pollock’s fundamental optimism reveals itself. Chapter 15 explores how our living standards have increased dramatically over the past centuries. The real per capita gross domestic product in the US today is 8.6 times what it was in the year 1900: “This represents an average real annual growth rate of 1.9 percent over the 116 years. Such sustained growth is an astonishing achievement of the in innovative, enterprising economy.”

In this chapter Mr. Pollock turns the previous chapters on their heads: In theory, presumably some absurd excess of financial caution in which nothing is ever risked, nothing is ever invested, and no entrepreneurs exist, would reduce the cases of booms and busts. But there would also be no economic growth... Sustained growth depends on entrepreneurship and entrepreneurship always creates uncertainty. This means that uncertainty is at the center of both growth and cycles. (Emphasis added)

What is to be done? Chapter 16 offers conclusions for regulators and central banks. Should government intervene in the financial system or not? The answer, Pollock says, is different at different times: “In ordinary times, we want economic efficiency, innovation, risk taking, productivity and the resulting economic well-being of ordinary people that only competitive private markets can create. But when the financial system hits periodic crises and panic, we want the intervention and coordination of the compact power of the government.”

In short, government should adopt a “Cincinnatian Doctrine.” It seems likely that government will have the mandate for large-scale intervention only once a crisis and financial panic occur. However, once the crisis is past, and normal market functions can return, then the government should withdraw: “This is an essential point. If prolonged they [i.e., crisis interventions] will lead to monopoly, more bureaucracy, less innovation, less risk-taking, less growth, and less economic well-being.”

But what about trying to predict crises to reduce their impact? In Chapter 17, Mr. Pollock proposes to create a “systemic risk advisor” to try to track developments in the financial markets, much as today’s Office of Financial
Research is supposed to do. Given the distorting effects of power on an organization’s ability to maintain a dispassionate point of view, Mr. Pollock prescribes that the systemic risk advisor should not be a regulator. The U.S. has such an organization in the transportation sector, the National Transportation Safety Board (NTSB). Without regulatory authority, the NTSB is charged solely with investigating transportation accidents and issuing dispassionate reports with recommendations that industry and relevant federal agencies might or might not welcome.

The book closes in Chapter 18 with a call to virtue: “Especially because those of us in any kind of financial responsibility are constrained by limits to our knowledge, fundamental uncertainty, and inevitable mistakes, we should strive at all times to practice the financial virtues. Loyalty and prudence, and along with them, integrity and temperance, demand constant effort, by precept and by example.”

In the 35 years of his career, Alex Pollock was a banker with those virtues, and we all can learn from him and his fine book.