Greed and Stupidity
By DAVID BROOKS

What happened to the global economy? We seemed to be chugging along, enjoying moderate business cycles and unprecedented global growth. All of a sudden, all hell broke loose.

There are many theories about what happened, but two general narratives seem to be gaining prominence, which we will call the greed narrative and the stupidity narrative. The two overlap, but they lead to different ways of thinking about where we go from here. The best single encapsulation of the greed narrative is an essay called “The Quiet Coup,” by Simon Johnson in The Atlantic (available online now).

Johnson begins with a trend. Between 1973 and 1985, the U.S. financial sector accounted for about 16 percent of domestic corporate profits. In the 1990s, it ranged from 21 percent to 30 percent. This decade, it soared to 41 percent. In other words, Wall Street got huge. As it got huge, its prestige grew. Its compensation packages grew. Its political power grew as well. Wall Street and Washington merged as a flow of investment bankers went down to the White House and the Treasury Department.

The result was a string of legislation designed to further enhance the freedom and power of finance. Regulations separating commercial and investment banking were repealed. There were major increases in the amount of leverage allowed to investment banks.

The U.S. economy got finance-heavy and finance-mad, and finally collapsed. When it did, the elites did what all elites do. They took care of their own: “Money was used to recapitalize banks, buying shares in them on terms that were grossly favorable to the banks themselves,” Johnson writes.

In short, he argues, the U.S. financial crisis is a bigger version of the crises that have afflicted emerging-market nations for decades. An oligarchy takes control of the nation. The oligarchs get carried away and build an empire on mountains of debt. The whole thing comes crashing down.

Johnson’s remedy is clear. Smash the oligarchy. Nationalize the banks. Sell them off in medium size pieces. Revise antitrust laws so they can’t get back together. Find ways to limit executive size pieces. Revise antitrust laws so they can’t get back together. Find ways to limit executive compensation. Permanently reduce the size and power of Wall Street.
The second and, to me, more persuasive theory revolves around ignorance and uncertainty. The primary problem is not the greed of a giant oligarchy. It’s that overconfident bankers didn’t know what they were doing. They thought they had these sophisticated tools to reduce risk. But when big events — like the rise of China — fundamentally altered the world economy, their tools were worse than useless.

Many writers have described elements of this intellectual hubris. Amar Bhidé has described the fallacy of diversification. Bankers thought that if they bundled slices of many assets into giant packages then they didn’t have to perform due diligence on each one. In Wired, Felix Salmon described the false lure of the Gaussian copula function, the formula that gave finance whizzes the illusion that they could accurately calculate risks. Benoit Mandelbrot and Nassim Taleb have explained why extreme events are much more likely to disrupt financial markets than most bankers understood.

To me, the most interesting factor is the way instant communications lead to unconscious conformity. You’d think that with thousands of ideas flowing at light speed around the world, you’d get a diversity of viewpoints and expectations that would balance one another out. Instead, global communications seem to have led people in the financial subculture to adopt homogenous viewpoints. They made the same one-way bets at the same time. Jerry Z. Muller wrote an indispensable version of the stupidity narrative in an essay called “Our Epistemological Depression” in The American magazine. What’s new about this crisis, he writes, is the central role of “opacity and pseudo-objectivity.” Banks got too big to manage. Instruments got too complex to understand. Too many people were good at math but ignorant of history.

The greed narrative leads to the conclusion that government should aggressively restructure the financial sector. The stupidity narrative is suspicious of that sort of radicalism. We’d just be trading the hubris of Wall Street for the hubris of Washington. The stupidity narrative suggests we should preserve the essential market structures, but make them more transparent, straightforward and comprehensible. Instead of rushing off to nationalize the banks, we should nurture and recapitalize what’s left of functioning markets.

Both schools agree on one thing, however. Both believe that banks are too big. Both narratives suggest we should return to the day when banks were focused institutions — when savings banks, insurance companies, brokerages and investment banks lived separate lives.

We can agree on that reform. Still, one has to choose a guiding theory. To my mind, we didn’t get into this crisis because inbred oligarchs grabbed power. We got into it because arrogant traders around the world were playing a high-stakes game they didn’t understand.

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