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Flaming Eggheads! Nobel-Winning Economist In Dustup Over Loose Lending

Harvard economist inadvertently demonstrates the Knowledge Problem at a Hayek event.

By Tim Cavanaugh
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A Nobel Prize–winning economist got a smackdown on Thursday after calling for heavier regulation in housing finance while at the same time conceding he knew little of the role government and quasi-government agencies played in creating the housing bubble of the 1990s and 2000s.

“I don’t want to comment on Freddie and Fannie. I’m not a housing market expert and I don’t want to pretend to be one,” Eric Maskin, Adams University Professor at Harvard University, said during a panel of eggheads at George Mason University commemorating the 40th anniversary of Friedrich A. Hayek’s Nobel Prize in economics. “But I do want to make a general comment about regulation of financial markets. One thing that we learned from the financial disaster of six years ago was something that economic theorists had been talking about for years, which is that financial markets are riddled with externalities.”

Maskin, who was responding to a proposal from Hillsdale College economics professor Ivan Pongracic to eliminate the government-sponsored entities (GSEs), elaborated: “In particular, if I’m a bank and I’m making risky loans, I have an incentive, if I can, to make those loans using other people’s money, in other words to make highly leveraged loans. But when I do that I don’t take into account the fact that if the loan goes bad it’s not just me who fails but all of my creditors. In other words I’m creating systemic risk by making these loans on borrowed money. That’s an externality which I have no incentive as a bank to take into account. And the only way that that externality will be taken into account is if someone else, a regulator for example, puts a limit on leverage. That’s a simple lesson from economic theory that was ignored six years ago. I hope it won’t continue to be ignored.”

That comment drew a strong rebuke from an economist in the audience.

“How did you arrive at the conclusion that the housing subprime boom was evidence of a market failure as someone who professedly doesn’t claim to be an expert in housing markets or to even have an opinion about the role Fannie and Freddie played in that failure?” Cato Institute senior fellow George Selgin, an economics professor at the University of Georgia, shot back. “That’s something of a non sequitur.”

Throughout the late 1990s and early 2000s, Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) — government-sponsored

entities created during the Johnson/Nixon era to provide easy credit to the mortgage market — purchased an increasing percentage of U.S. mortgages, while downplaying how many of those were junk such as alt-A, negative amortization, very-high-loan-to-value, and other less reliable loans. Since not all of these were labeled "subprime" (due to the GSEs' very selective definition of a subprime loan), their risky nature did not become known until well after the partial correction of the decades-overinflated real-estate market had begun in 2006. In fact, the GSEs did not reveal the full extent of such loans in their portfolios until after they went bankrupt and were put into a Treasury Department conservatorship in 2008.

The GSEs now operate as fully governmental agencies rather than government-sponsored businesses, and rather than having their roles in the housing market reduced, they have continued to increase the share of mortgages they guarantee. As of 2010, the GSEs guaranteed 63 percent of U.S. mortgages, and in that same year the Congressional Budget Office estimated that, including the GSEs as well as the Federal Housing Administration, the federal government guaranteed more than 90 percent of private mortgages in the United States.

Thus Maskin's implication that cooler heads in centralized agencies could have averted the housing bubble and subsequent correction met with few takers in a roomful of followers of Hayek. The late Austrian economist's 1974 Nobel acceptance speech was titled "The Pretense of Knowledge," and his academic contribution included a close consideration of the "knowledge problem" — the simple but significant insight that information is broadly dispersed in markets and not manageable or even knowable by any central authority. This is some distance from the work of Maskin, whose own award was for his work in mechanism design theory. The 2007 Nobel citation praised Maskin, along with Leonid Hurwicz and Roger Myerson, for a theory that "enhanced our understanding of the properties of optimal allocation mechanisms" and "allows us to distinguish situations in which markets work well from those in which they do not," adding that the theory was useful in helping to design "efficient trading mechanisms, regulation schemes and voting procedures."

But the George Mason crowd seemed determined to show the Nobel laureate how little he knows about what he imagines he can design. Though Maskin's claim of non-expertise appeared to be simply a courteous expression of humility, he doubled down on his smarter-than-thou argument as Selgin pressed him from the audience.

"When I say I'm not an expert, and I'm not, I mean I don't have opinions such as what particular government program should or should not exist," Maskin continued. "One doesn't have to be an expert in financial markets, though, to know that there are huge externalities. And simple economic theory, the economic theory that we teach our first-year graduate students, is enough to tell us that those markets left unregulated will not work very well. So I'm not proposing the solution but I've diagnosed the problem."

"If I may," Selgin went on, "I think a closer look at what Fannie and Freddie did might change your mind about whether those mortgages would ever have been created if there had not been an agency prepared to buy them all. It does matter what government does, whether markets are functioning as one wants them to or otherwise."

“You won’t get any objection from me that it matters what government does,” Maskin replied, getting a laugh from the audience.

In comments received after initial publication of this article, Maskin suggested the government is capable of regulating itself. “I don’t want to make public statements about issues that I have not studied in detail,” Maskin said in an e-mail to National Review Online, “and so I won’t comment on the particular policies that Fannie and Freddie followed. But let me say, more generally, that to be effective, financial regulations should apply to government as well as to private institutions.”

Maskin also pointed up a distinction that may have been lost on the crowd: that his comments were directed solely at financial markets, not housing markets. “I took particular care not to say anything about the housing market.. I was talking about financial markets in general, not housing,” he told NRO. “I never said that the housing market needs more regulation.”

Maskin was participating in a planned panel of Nobelists that included 2002 laureate Vernon Smith of Chapman University in California and 2008 laureate Edmund Phelps of Columbia University in New York City. However, in exactly the kind of unrelated event that makes mechanism design so deucedly difficult, Phelps was taken ill while traveling and was unable to participate.

In his email, Maskin allowed that the Hayek-happy crowd had given him a fair shake. “I do think I got a fair hearing,” Maskin told NRO. “A few questioners appeared to be skeptical of some of the things I said. But that is entirely appropriate in a forum whose purpose is to probe ideas.”

Nearly a decade after hyperinflated real-estate prices finally began their descent, the event was still dominated by the 2006–10 credit unwind and the lengthy economic stagnation that continues in its wake. In a press gaggle, Smith, whose Nobel was awarded for development of methods for laboratory experiments in economics and who recently co-authored the book *Rethinking Housing Bubbles* with Steven D. Gjerstad, expanded on his belief that the economic stagnation would have been less punishing and lengthy had the two seriously insolvent gigantibanks — Citigroup and Bank of America — been allowed to fail. Noting that nearly 500 banks did in fact go out of business, Smith compared the unraveling of these financial institutions to the unwinding of seriously distressed savings and loans in the 1980s. “The model was tested in the S&L crisis,” he said. “It’s a lot bigger scale, which makes it scary.”

National Review Online asked why real-estate prices have begun to reinflate even though, as a multiple of household income, house prices remain significantly higher than they were through most of postwar history. Smith noted that a third of those are cash sales.

“American houses look cheap to the Chinese,” he said. “But it’s not sustainable, because usually increases in house prices are related to increases in income, but that’s not happening here.”

Correction: An earlier version of this article misquoted Maskin. His reference to “financial markets” was incorrectly rendered as “housing markets.” Maskin’s initial comment at the event is reproduced above in its entirety.