

Robert J.  
Shiller

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Finance  
*and the*  
Good  
Society

# *Finance and the Good Society*

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**Robert J. Shiller**



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# ***Finance and the Good Society***

## ***Preface***

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I started writing this book initially for my students in the finance class I have been teaching for twenty-five years at Yale University. Many of these young people, I believe, still have not figured out their places in the world and are wondering how their goals and dreams will meet hard reality. In writing this book, I wanted to help them understand the modern system of financial capitalism in which they must live, now and in decades hence, whatever their career choices.

Since 2008 this class has been available online via the videos of all my lectures produced for the public by Open Yale Courses, and a new video version of my lectures is appearing in 2012.<sup>1</sup> The needs of my distant students who watch the lectures online from all over the world have also contributed to my motivation to write this book.

But since I started working on it this book has taken on a larger and more urgent purpose, and not just for students. We all live our lives in a world of financial capitalism—an economic system that is increasingly guided by financial institutions and that, in the wake of the severe financial crisis that began in 2007, appears to many to be broken. We all need to consider whether this society is even going in the right direction, in both our lifetimes and the lifetimes of our children.

Financial capitalism is an invention, and the process of inventing it is hardly over. The system has to be thoughtfully guided into the future. Most importantly, it has to be further expanded and democratized and humanized, so that we may reach a time when financial institutions will be even more per-

vasive and positive in their impact. That means giving people the ability to participate in the financial system as equals, with full access to information and with the resources, both human and electronic, to make active and intelligent use of their opportunities. It will mean that they truly consider themselves part of modern financial capitalism, and not the victims of the aggressive and selfish acts of a cynical financial establishment. It will mean designing new financial inventions that take account of the most up-to-date financial theory, as well as the research revolution in behavioral economics and behavioral finance that has explored the real human limitations that inhibit rational and humane decision making. Creating and implementing such inventions will be the best tactic to deal with economic inequality. This future is in the hands of the people, old as well as young, who might read this book.

This matter is especially apparent at the time of this writing, as many countries around the world still struggle with the effects of the financial crisis that began in 2007. It is hard to be precise in dating this crisis, since as I write in 2012 we certainly do not believe that it is over yet, and the worst may be yet to come. Efforts by governments to solve the underlying problems responsible for the crisis have still not gotten very far, and the “stress tests” that governments have used to encourage optimism about our financial institutions were of questionable thoroughness.

Public street protests against both government and the financial establishment were front-page news in 2011, long after the writing of this book had gotten under way. The protests apparently took their inspiration from those of the Arab Spring against dictatorial governments in the Middle East. They began to be directed against the financial establishment with the Movimiento 15-M in Madrid, then with Occupy Wall Street in New York, along with Occupy Boston, Occupy Los Angeles, Occupy London, Occupy Melbourne, Occupy Rome, and other variants. The December 2011 election protests in Russia reflected dissatisfaction with the cozy situation of rich “business oligarchs.” The most consistent theme in all these movements has been a plea for better democracy, lamenting a perceived conspiracy between governments and their associated financial establishments. While their arguments and rhetoric are not always coherent, the protests represent, in substantial measure, a welcome assertion of democratic values and citizen responsibility.

The movements are not necessarily left-wing. Even those who consider themselves the ideological opposite of Occupy Wall Street in the United States, the right-wing Tea Party activists, also seem upset by the apparent concentration of wealth and power in New York and other financial centers, while “middle America” does all the work. There seems to be almost universal agreement, by those of all political persuasions, that wealthy financial interests should not use their influence over government to grab more wealth, as seems to have been the case in events leading up to and following the crisis. But as to what should be done next, there is much less agreement.

Many people seem fixed on the idea that those responsible for the financial crisis should go to jail. In late 2011 I gave an evening talk, sponsored by the Chicago Council on Global Affairs, to a large audience, apparently mostly businesspeople. Some in the audience angrily criticized me afterward for failing to stress the many charges of fraud leveled against financial firms in the wake of the crisis. I was surprised to hear such anger from those in the business community—hardly street protesters and probably both Republicans and Democrats. I was equally surprised to see that my basic theme—the need to democratize finance by making the financial markets work better for all people—was not seen as more sympathetic to their concerns. In fact, this theme would appear to promote the deepest objectives of Occupy Wall Street.

While it is impossible to overlook illegality as one cause of the current financial breakdown, I believe that in situating the problem there we fail to appreciate the big picture. We have a financial system that malfunctioned because of a host of factors. If we do not address the deeper sources of these problems by improving the system, we will have missed the point of the problem—and the opportunity to correct it.

Certainly anyone who committed fraud should suffer penalties. But it is hard to blame the crisis on a sudden outbreak of malevolence. The situation during the boom that created the crisis was rather more like that on a highway where most cars are going a just a little too much over the speed limit. In that situation, well-meaning drivers will just flow with the traffic. The U.S. Financial Crisis Inquiry Commission, in its final 2011 report, described the boom as “madness,”<sup>2</sup> but, whatever it was, it was not for the most part criminal.

And, pursuing this highway metaphor a bit further, we may suggest that automotive designers would best stay focused on how new technology can help us better manage vehicular traffic, with improved cruise control, external electronic feedback to cars, and ultimately even self-driving cars—complex new systems that will enable people to reach their travel destinations more easily and more safely. If that’s the future for our highways, something like it should be the future for our financial institutions as well.

All of these protest movements are only the most manifest signs of discontent that have been discernible in conversations and blogs ever since the financial crisis began. The words of street protesters and angry businesspeople alike are without focus and offer us no clarity about what is wrong or what should be done. And yet the underlying dissatisfaction with our financial system, in the wake of the financial crisis, reflects real problems with the system that need to be fixed—problems that have not yet been solved by the new legislation and regulations put forward in the wake of the crisis.

The financial crisis became visible in the United States when home prices started to fall after 2006. According to our Standard & Poor’s /Case-Shiller national home price index, real U.S. home prices fell 40% over the five years from 2006 to 2011. By 2007 this decline had brought prices of home mortgage

securities down far enough to create a crisis for investors in these securities. It was called the *subprime crisis* because the price falls were especially striking among mortgages issued to subprime borrowers, that is, home buyers who are judged more likely to default because of factors including their past payment and employment histories. Financial innovations related to these subprime loans were blamed for the crisis. But the crisis did not remain confined to subprime mortgages; that was only the initial shock in a vast catastrophe. The consequence was a drop in real estate prices and the collapse of financial institutions, not only in the United States but also in Europe and elsewhere. By the spring of 2009 the crisis was so severe that it was described as the biggest financial calamity since the Great Depression of the 1930s—bigger than the Asian financial crisis of the 1990s and bigger than the oil-price-induced crises of 1974–75 and 1981–82. Beginning in 2010 it was complicated by a European sovereign debt and banking crisis, which by 2012 resulted in many downgrades of governments' debt, and even of the Eurozone's bailout fund, the European Financial Stability Facility. This crisis continues to have repercussions around the world.

Despite the problems in the mortgage business and many large financial institutions—some based simply on overenthusiasm and naïveté, others on outright efforts to manipulate and to defraud—I never felt, as did so many, that these problems were a damning indictment of our entire financial system. Imperfect as our financial system is, I still find myself admiring it for what it does, and imagining how much more impressive it can be in the future.

I realize that critics might think that preparing students for careers in finance merely exacerbates a trend toward greater economic travail for the many. Certainly some who work in finance or related fields often reap great material rewards for their efforts, while others earn far less. Modern society is indeed currently on a trend toward higher levels of economic inequality,<sup>3</sup> and contributing to that trend has been the tendency to reward especially well some of those who go into activities that relate to finance, while those who make their livings primarily in other sectors of the economy, including most of the middle class and the poor, lose ground. The government bailouts of well-to-do bankers have redoubled public concerns about inequality.

But finance should not be viewed as inherently or exclusively elitist or as an engine of economic injustice. Finance, despite its flaws and excesses, is a force that potentially can help us create a better, more prosperous, and more equitable society. In fact, finance has been central to the rise of prosperous market economies in the modern age—indeed this rise would be unimaginable without it. Beyond headlines incriminating bankers and financiers as self-aggrandizing perpetrators of economic dislocation and suffering, finance remains an essential social institution, necessary for managing the risks that enable society to transform creative impulses into vital products and services, from improved surgical protocols to advanced manufacturing technologies to sophisticated scientific research enterprises to entire public welfare systems.



The connections between financial institutions and individual people are fundamental for society. Clarifying the terms of these connections and establishing a proper context for implementing and enhancing them is the subject of this book.

It seems a paradox that the very financial system that is the facilitator of some of our greatest achievements can also implode and create such a disaster. Yet the best way for society to proceed is not to restrain financial innovation but instead to release it. Such an approach can reduce the impact of such disasters and at the same time democratize finance. At various points in this book I describe financial innovations currently being developed, and I also propose newer innovations, as examples of how creative and well-meaning people can still further improve our society and democratize its finance.

But the financial crisis reminds us that innovation has to be accomplished in a way that supports the stewardship of society's assets. And the best way to do this is to build good moral behavior into the culture of Wall Street through the creation and observance of best practices in its various professions—CEOs, traders, accountants, investment bankers, lawyers, philanthropists.

When Adam Smith wrote his classic *Wealth of Nations* in 1776, a book long acclaimed as marking the beginning of modern economics, the pressing issue for thinkers and critics of the day was tariffs.<sup>4</sup> Private interests lobbied governments to put their interests ahead of public interests and push tariffs up so high as to make it impossible for lower-cost foreign producers to compete. But Adam Smith and other economists who followed him were successful in clarifying the importance of trade for the widespread wealth of nations. Since Adam Smith, lobbyists for special interests have found it much harder to push up tariffs, and trade is substantially free today—a vital institution in creating the remarkable growth and widespread prosperity we have seen since the revolutions of the eighteenth century.

At this time of severe financial crisis the point of contention among thinkers and critics is not trade but finance itself. Hostility runs high toward societal institutions that are even tangentially associated in people's minds with finance. This hostility is reminiscent of the public state of mind during the last major world financial crisis—the Great Depression after 1929—which led ultimately to a degree of unrest that shut down much of the world economy and contributed to the tensions that led to World War II.

Hostility among the general public generated by the crisis may have the unfortunate effect of inhibiting financial progress. Ironically, better financial instruments, not less activity in finance, is what we need to reduce the probability of financial crises in the future. There is a high level of public anger about the perceived unfairness of the amounts of money people in finance have been earning, and this anger inhibits innovation: anything new is viewed with suspicion. The political climate may well stifle innovation and prevent financial capitalism from progressing in ways that could benefit all citizens.

To be sure, financial innovation is still percolating, at a slow and conservative level, but major new financial inventions cannot be launched now because of fear. In this book I contend that the financial crisis was not due simply to the greed or dishonesty of players in the world of finance; it was ultimately due to fundamental structural shortcomings in our financial institutions. Yet such shortcomings as a failure to manage real estate risk or a failure to regulate leverage are still not really being addressed; the response to the crisis has not been to innovate confidently to address areas where our institutions failed. Instead, the main focus has been on avoiding bailouts and reducing national debt by curtailing government spending. Initiatives developed by politicians in response to public anger have been shaped by what the public perceives as the problem, not by the contributions of visionaries.

Socially productive financial innovations could be moving forward rapidly, given the information revolution and with so many more countries experimenting with different economic structures and competing in the world marketplace. In coming decades we could see rapid development in the breadth of financial contracts, with extensions in the scope of markets, for the purpose of safeguarding our fundamental economic assets. Innovations could include the implementation of new and better safeguards against economic depression, including the proliferation of new kinds of insurance contracts to allow people to be more adventuresome in their lives without fear of economic catastrophe. We could also see innovative measures developed to curtail the rising plague of economic inequality that threatens to create serious social problems in our society.

What I want most for my students—near and far, young and old—to know is that finance truly has the potential to offer hope for a more fair and just world, and that their energy and intelligence are needed to help serve this goal.

### *Acknowledgments*

My student research assistants here at Yale—Oliver Bunn, George Cook, Duck-Ju Kang, Bin Li, Michael Love, Lindsey Raymond, Kate Stratton, Argyris Tsiaras, and Rachel Wang—were my eyes and ears as I wrote this book. I also got important feedback from the students in my finance class at Yale, where an early draft of this book was assigned as a supplement to the textbook. I wanted a youthful perspective. I wanted to see the financial world from the vantage point of those whose lives are still taking shape, who are launching their careers, whether in finance or in other fields—and they came through wonderfully for me.

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I thank the Public Lectures Committee at Princeton University, who invited me to give the 2010 Walter Edge Lecture, "Finance and the Good Society," in which I presented, and received feedback on, an earlier version of the ideas set forth in this book.

I am indebted to Peter Dougherty, director of Princeton University Press, for his great help in conceptualizing and developing the book. Thanks are also due to everyone at the press and indeed to the book publishing industry as a whole, for promoting the broader discourse that ultimately made this book possible.

I am a believer in achieving understanding through *books*, not just scholarly articles in professional journals, since I believe that the more comprehensive discussion of a topic that books permit ultimately leads to a broader understanding of any subject. This book began as a work for my students, and I included many references to books for them, as any good teacher would. Yet even after I had decided that this was really a book for the general public and not just for students, I persisted in including numerous references. I believe it is important for all readers, including my professional colleagues, to spend time with whole, readable books on broad topics rather than just the specialized scholarly literature. I do not think of these books as popularizers, but as synthesizers, originators, provokers, and inducers. That is how I view this book—and hope others will as well.

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## Introduction: *Finance, Stewardship, and Our Goals*

What are we to make of a book called *Finance and the Good Society*? To some readers, this may seem an incongruous coupling of concepts. The word *finance* is commonly thought of as the science and practice of wealth management—of enlarging portfolios, managing their risks and tax liabilities, ensuring that the rich grow richer. We will revisit—and challenge—this definition of finance later in this chapter. The phrase *good society* is a term used by generations of philosophers, historians, and economists to describe the kind of society in which we should aspire to live; it is usually understood as an egalitarian society, one in which all people respect and appreciate each other. So at first glance *finance*, at least as commonly understood, seems to be working *against* the achievement of the *good society*.

But it is not so simple. Finance has become ever more associated with *capitalism*. Since the Industrial Revolution, intellectuals have focused their often heated debates about the good society on issues related to capitalism, including the system of markets, private property, legal rules, and class relations. These institutions and issues have increasingly come to define modern society throughout the world. Along with democracy, few ideas have been as pervasive and contentious in defining the good society as capitalism.

Debates about capitalism and the good society, from Karl Marx's incendiary criticisms in the nineteenth century through Milton Friedman's spirited defenses of free markets in the twentieth, have tended to center on *industrial capitalism*: the system of production, banking, and trade that shaped modern society up through the end of World War II. But the past several decades have

witnessed the rise of *financial capitalism*: a system in which finance, once the handmaiden of industry, has taken the lead as the engine driving capitalism. Much ink has been spilled over the purely economic aspects of financial capitalism. I too have contributed to this discussion, in my scholarly writings on market volatility and in books such as *Irrational Exuberance*. The current severe financial crisis has called forth questions not only about the system's parts but also about financial capitalism as a whole. This crisis—dubbed by Carmen Reinhart and Kenneth Rogoff as the “Second Great Contraction,” a period of weakened economies around the world starting in 2007 but continuing for years after, mirroring the Great Contraction that followed the financial crisis of 1929—has led to angry rejections of the value of financial capitalism.

Given this experience, many wonder, what is the role of finance in the good society? How can finance, as a science, a practice, and a source of economic innovation, be used to advance the goals of the good society? How can finance promote freedom, prosperity, equality, and economic security? How can we democratize finance, so as to make it work better for all of us?

### ***What's in a Phrase? Financial Capitalism Evolving***

The term *financial capitalism* developed negative connotations as soon as it first became popular in the 1930s with the publication of George W. Edwards's *The Evolution of Finance Capitalism*.<sup>1</sup> Edwards saw a conspiracy of large financial institutions, with J. P. Morgan at the lead. He called it the *Pax Morgana*. During the Great Depression critics and much of the public at large blamed the financial system for their plight; they viewed the system as almost feudal, with financiers replacing the lords.

The term has recently been revived, and again it is used with hostility. President Nicolas Sarkozy of France has said,

Purely financial capitalism has perverted the logic of capitalism. Financial capitalism is a system of irresponsibility and is . . . amoral. It is a system where the logic of the market excuses everything.<sup>2</sup>

Tony Blair, former British prime minister, speaking of the severe financial crisis that began in 2007, remarked,

What is plain is that the financial system has altered its fundamentals, and can never be the same again. What is needed is radical action to deal with the fallout of the crisis.<sup>3</sup>

Grigory Yavlinsky wrote the 500 Days Program of 1990, which outlined the Russian transition to a free-market economy, and was promoted to deputy prime minister to implement it. He began to express similar doubts after the crisis. In his 2011 book *Realpolitik*, in a section entitled “Structural Shift: From Industrial Capitalism to Financial Capitalism,” he noted that



the fundamental structural shifts [are] directly related to a gradual slackening of moral constraints in developed countries. Structural shifts like these follow very fast growth of the financial sector and services directly related to it.<sup>4</sup>

I argue in this book that while critics are correct in some of their indictments, the changes that must be made, rather than having the effect of constraining the innovative power of financial capitalism, should instead broaden its scope. We will make little progress if we simply condemn financial capitalism as a “system of irresponsibility.” But we have the potential to support the greater goals of good societies—prosperous and free societies in the industrialized as well as the developing world—if we expand, correct, and realign finance.

### ***The Inexorable Spread of Financial Capitalism***

At the time of this writing we are still stuck in the severe financial crisis that began in 2007. As such we tend to associate finance with recent problems, such as the mortgage and debt hangovers in the United States and Europe, and with the legal and regulatory errors that preceded these events. But we should not lose sight of the bigger picture. The more important story is the proliferation and transformation of successful financial ideas. Financial innovations emanating from Amsterdam, London, and New York are developing further in Buenos Aires, Dubai, and Tokyo.

The socialist market economy, with its increasingly advanced financial structures, was introduced to China by Deng Xiaoping starting in 1978, adapting to the Chinese environment the examples of other highly successful Chinese-speaking cities: Hong Kong, Singapore, and Taipei. The economic liberalization of India, which allowed freer application of modern finance, was inaugurated in 1991 under Prime Minister P. V. Narasimha Rao by his finance minister (later prime minister) Manmohan Singh, who was educated in economics at Nuffield College, Oxford University. The voucher privatization system introduced to Russia in 1992–94 under Prime Minister Boris Yeltsin by his minister Anatoly Chubais, following a modification of the Yavlinsky plan, was a deliberate and aggressive strategy to transform Russia’s economy. The intent was not simply to match the rest of the world in the degree to which finance permeated the daily lives of the Russian people, but to have Russia rank first in the world in public ownership of capital.

Such sudden integrations of sophisticated financial structures, originally designed in more financially advanced countries, were not achieved entirely smoothly in these countries, and there was a degree of anger about the inequality of benefits that accrued to some, as opportunists amassed great wealth quickly during the transitions. But China, India, and Russia have seen a flourishing of financial sophistication and amazingly high economic growth rates. And it is not just these countries. According to International Monetary Fund