College of Business Book Review by Bruce Runyan

Title: “Freefall: America, Free Markets, and the Sinking of the World Economy”

Authors: Joseph E. Stiglitz

Publisher: W. W. Norton and Company

Length: 361

Price: $27.95

Reading time: 12 hours

Reading Rating: 6 (1 = very difficult; 10 = very easy)

Overall rating: 4 (1 = average; 4 = outstanding)

What happened and what do we do now? Joseph E. Stiglitz provides answers to these questions in his book Freefall: America, Free Markets, and the Sinking of the World Economy. More specifically, “This book explains how flawed perspectives led to the crisis, made it difficult for key private-sector decision makers and public-sector policymakers to see the festering problems, and contributed to policymakers’ failure to handle the fallout effectively.” The book also seeks to “help us understand better the post-crisis global order that eventually will arise and how what we do today will help shape it for better or worse.”

The book accomplishes its objectives by first describing the financial environment, with emphasis on incentives of the key players, which led to the financial collapse. The incentives of home owners, mortgage originators, banks, rating agencies, regulators and investors are tied together with information asymmetry and ill-conceived financial products. Securitization of bundled mortgages allowed banks to replace long-term investments with cash, but, as Stiglitz points out, “… created several new problems. One was that it created information asymmetries: the buyer of the security typically knew less than the bank or firm that originated the mortgage. And because the originator didn’t bear the consequences of his mistakes (except in the long-run – through the loss of reputation), his incentives for doing a good job at credit assessment were greatly attenuated.”

Much of this process is now familiar. Less familiar, however, are the insights that our respected regulators were recommending that consumers take on higher risk and that other countries are more effective at regulating mortgage risk and dealing with mortgages in trouble. From the book, “Greenspan had, in effect, advised the country to take an extraordinarily risky course [with adjustable-rate mortgages]. Other countries like Turkey simply did not allow variable-rate mortgages. In the United Kingdom, many of the variable-rate mortgages still keep a fixed payment, so individuals aren’t forced into foreclosure. Instead, banks lengthen the amount of time over which the mortgage is repaid, …”

The book is much more than a recap of the crisis origins. Particularly insightful is the discussion of the types of stimulus and their differential effects. Stiglitz provides seven principles for an effective stimulus; it should be fast, effective, fair, address the country’s long-term problems, focus on investment, target areas of job loss, and it should deal with the most urgent short-run needs. The lynch-pin to successful economic stimulus is the multiplier effect. A dollar in the hands of people who will spend that dollar will stimulate the economy. A dollar in the hands of people who will tuck the dollar away will not. Examples of good stimulus are aid to states to make payrolls, liquidity to local and regional banks that provide credit to businesses, and to the unemployed to live another day. Examples of bad stimulus, i.e. providing liquidity to those who will not spend it, are tax cuts (or tax cut extensions) for the wealthy (the wealthy save a larger proportion of their income than the rest of us) and cash to big banks bent on rebuilding their balance sheets instead of providing credit. His explanation of economic stimulus (and why the results have been mixed) provides a standard by which to judge legislation currently under consideration.

Stiglitz answers the “what now?” question at length, including scenarios in dealing with the debt hangover. His admonition to “take this moment as one of reckoning and reflection, of thinking about what kind of society we would like to have, and ask ourselves, Are we creating an economy that is helping us achieve those aspirations?” is timely. Freefall provides input into that reflection and is highly recommended for anyone who desires a well-written perspective from one of Keynesianism’s most respected voices.

Bruce W. Runyan is an Assistant Professor of Accounting in the College of Business at Western Carolina University. His interests include financial reporting and regulation, decision-making, and valuation. For previously reviewed books, please visit our Web site at www.wcu.edu/cob