



## Is the “Chicago School” to Blame in the Economic Crisis?

*Michael Mussa, a former student and professor at the University of Chicago, assesses the influence—for good and for ill—of economics as espoused at the University of Chicago.*

*Recorded October 14, 2009. © Peterson Institute for International Economics.*

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Michael Mussa is our guest today to talk about whether the University of Chicago School of Economics shares any of the blame for the recent global financial crisis and downturn. I’ll explain why I’m asking him that in a second. Michael, thank you for agreeing to have this somewhat unusual conversation.

Michael Mussa: Well, it’s a pleasure to be here. It is unusual, but we shall see.

Steve Weisman: In addition to his many other achievements, notably as a senior fellow here, but also as the chief economist at the IMF and a member of President Reagan’s Council of Economic Advisers, Dr. Mussa taught and studied at the University of Chicago for something like more than 15 years.

Michael Mussa: Between studying and teaching—about 20 years actually.

Steve Weisman: The University of Chicago magazine has a cover story: “Is the Chicago School Thinking to Blame?” That is, to blame for the crisis. What is meant by that question?

Michael Mussa: There are sort of two strains of thought in which Chicago was a leading intellectual center that are probably relevant here. One is the general notion of the desirability of deregulation, including deregulation in the financial sector. And the other is a more abstruse theory of the real business cycle theory, which is associated with the names of some prominent economists who’d spent an important part of their careers at the University of Chicago. But of course, the Chicago School is much broader than that and one would normally think in this area of Milton Friedman whose monetary economics is really quite different from the real business cycle theory.

Steve Weisman: Let’s begin with the business cycle theory. What is it?

Michael Mussa: This is the notion that you can build up a theory of macroeconomic fluctuations based upon theories of individual maximizing behavior by firms and individual households in which there are substantial technological shocks, and it is these technological shocks that generate what we refer to as business cycles.

Steve Weisman: I’m not following you.

Michael Mussa: It’s abstruse. There’s no doubt about it.

Steve Weisman: Let’s take a plunge. What else could explain business cycles that this theory discounts?

Michael Mussa: The standard macroeconomic theory says that fluctuations in aggregate demand, and sometimes also in aggregate supply, perhaps are rising because of disruptions in the financial sector, which make it more difficult for firms and households to borrow and spend. That causes aggregate demand to fall, producing higher unemployment and so forth. When that process reaches a bottom, there's an actual process of upturn where the economy goes into recovery mode. That's sort of the standard business cycle theory. Many people say it's Keynesian but actually there are discussions of these issues for at least a century before Keynes wrote it.

Steve Weisman: One implication of this theory is that government spending or fiscal policy has a role to play or doesn't have a role to play in reversing or softening cycles.

Michael Mussa: It depends on exactly how the model is set up. In the early real business cycle models, there was not very much, if anything, that government policy either did to create business cycles or could do to undo them.

Steve Weisman: Well, that's historic, in other words.

Michael Mussa: Yes.

Steve Weisman: But in recent decades, according to Richard Nixon, we're all Keynesians. But, are we?

Michael Mussa: Well, in some degree yes. I think Keynes's influence is, in my judgment, somewhat overdone. There was a lot that Keynes has contributed, but the theory has been very much developed since the time that he was writing. He had to say it embodied much earlier thinking as well. So, it's the general evolution of macroeconomics which, I mean, a lot of editorials say has basically failed in the present crisis, which I think is, of course, total nonsense.

Steve Weisman: What are we seeing today in the context of business cycles?

Michael Mussa: As far as I can see, it's a kind of traditional, standard business cycle where we had an excess of lending and investment that came to an unfortunate end. That combined with severe problems of the development of the financial sector and deepened the financial crisis of the year ago, [and] produced an unusually deep and worldwide recession. This is by no means the only time we've seen this in the economic history of the United States. We've had a dozen or so of these episodes going back into the 1800s.

Steve Weisman: As you've pointed out, one of your professors at the University of Chicago has espoused a theory of these cycles that you've also espoused at many of our events and in some of your writing, that these cycles are...cyclical.

Michael Mussa: Most of them. Not quite all of them. But most of them occur because there is some negative disturbance that forces the level of output in employment below its normal level. Now that's often, but not always, preceded by an unsustainable boom. So you go from a boom to a bust, but the bust becomes excessive. Then, if you're well below the normal operating level of the economy, there is a natural force of recovery.

It's sort of like when you're beginning to get a cold or the flu. You begin to feel lousy and you know you're going to feel lousy for a while, but that is generally not a permanent state of affairs and as the body's immune system catches up, you then have a process of recovery, and that's sort of the theory of the business cycle. The economy gets sick, perhaps because it drank too much. Then it doesn't feel very well for a while but ultimately it recovers its equilibrium.

Steve Weisman: Circling back to the University of Chicago and the theory about cycles that is identified with the so-called Chicago School. Explain to me what about the Chicago School's particular theory might have been wrong, if not to blame for this crisis.

Michael Mussa: If we talk about the particular piece of it that is probably pointed to most, it's the notion that a completely deregulated financial market will be fundamentally stable and will not have these problems of periodic and sometimes severe disruptions.

Steve Weisman: So we're not talking about these cycles as the product of the University of Chicago School, but rather the theory of the value of regulation?

Michael Mussa: Yes, an extreme form of that philosophy—religion, whatever one wants to describe it as—to an extent at least, underlay the approach to financial deregulation that has taken place over the past 30 or 40 years, as we moved away from a quite tightly regulated financial system coming out of the 1930s until a much more liberal one.

Steve Weisman: This theory, which is identified mostly, but not of course exclusively, with the University of Chicago—you watched it take hold in your teaching and government service career, and perhaps go to extremes—what's your view?

Michael Mussa: I think there is some truth in the accusation that the deregulation got overdone and that contributed something to the development of the problems that were then manifested in the recent crisis. Now I hasten to point out that not everybody in Chicago held that view.

Steve Weisman: Yes.

Michael Mussa: I testified before congressional committees at least half a dozen times saying, "Well, we don't want to take deregulation too far or we're going to create problems." And I was not the only one who held that view.

If you read some of Milton Friedman's framework from monetary stability or Henry Simons's writings, they favored a so-called narrow banking system where banks would essentially hold only Treasury bills as the backing for transactions' balances. And of course, if you went that way then we couldn't have had the type of credit creation that banks and near-banks engaged in this cycle. So it wasn't a uniform view of everybody associated with the Chicago School but certainly it was a view held by many at the University of Chicago that a deregulated financial system would function better.

There are many who said, "Look, we need to be more careful about how much deregulated, that there is a fundamental instability in the financial system. We need to guard against that with deposit insurance and other mechanisms."

Steve Weisman: Why did it come to be identified with the University of Chicago? Because of Milton Friedman and his exalted status in the world of economics? Of course he went on to develop a whole body of work associated [with] a whole theory about the role of government beloved of conservatives especially?

Michael Mussa: Yes, interestingly in his monetary economics, Milton very strongly favored the deposit insurance system. He certainly strongly favored the central bank that would operate to prevent or ameliorate financial crises. And he blamed much of the Great Depression on the mismanagement of monetary policy that allowed the collapse of money and credit in the banking system to proceed much further than it needed to, if more effective action had been taken.

So Milton was not the advocate of the notion of the financial system is perfectly stable on its own, and we don't need government intervention in any form to keep it operating reasonably well.

Steve Weisman: Is there anyone who you think is responsible for taking a body of scholarship and studies of the causes of the Depression or other factors in the economy and just taking them overboard? I mean, what happened? Everyone seemed to become enamored of this starting in the 1970s and certainly into the 1980s.

Michael Mussa: Oh, indeed. The move to deregulate the economy and particularly the financial sector really does go back into the 1960s. It didn't suddenly all emerge in 1999 when they finally repealed the Glass-Steagall Act, but proceeded progressively through the creation of money market funds, through the broadening of banks' authority to invest in assets other than traditional commercial lending.

The capacity of nonbanks, brokerage firms, and so forth to engage essentially in banking activities, which has gotten us into a lot of difficulty—all of this sort of emerged over time. And there were many advocates of that point of view, and there are important reasons for wanting to move in that direction because a highly regulated system tends to have a lot of efficiencies associated with it.

Indeed, Sir Dennis Weatherstone, who was the head of JPMorgan Chase and has been one of the donors who supported this institute, was a very strong and practically effective advocate of banking regulation and very substantially expanding the range of activities in which JPMorgan Chase engages. So it was a very broad movement and there was much to recommend it and it had many advocates—not just in the University of Chicago and not just in the academic community. Probably the most influential in the end was Alan Greenspan.

Steve Weisman: That was the apotheosis, I suppose—his years at the Fed.

Michael Mussa: Yes, I think in my view that was part of the reason why Alan was appointed to replace Paul Volcker. Both James Baker, the secretary of Treasury and Donald Regan, the White House chief of staff, wanted somebody at the Fed who was more sympathetic than Volcker to financial deregulation. And President Reagan certainly had no reason necessarily to object to that. But I think that was Alan's position for many, many years before he went to the Federal Reserve. So it was not surprising that he brought that with him. He wasn't bought off by the banks. It was his deeply held belief.

Steve Weisman: He was an authentic libertarian in a number of areas...

Michael Mussa: Absolutely.

Steve Weisman: ...and a fan of Ayn Rand. That was his philosophy.

Michael Mussa: Yes, and he was also, I think, a quite shrewd politician, I mean, as he's pointed out, I think he's completely right about this. The Fed had the authority to regulate the mortgage market to a considerably greater extent than it exercised. He didn't want to do it. But he also sensed that if he did it, there would be a lot of opposition on both sides of the aisle in Congress because you're denying credit to less credit-worthy [borrowers] and the poor less. So there would have been a lot of objection if he had tightened the regulation in that area, and not just from the rabid deregulationists.

Steve Weisman: One of the things that you read, growing out of this crisis, is that economic orthodoxy has had a comeuppance. What's your sense of what's going on, not only in the University of Chicago but other graduate schools or business schools that are teaching economic policy? Are they rethinking some of their theories?

Michael Mussa: Well, certainly as to rethinking—of course! We have to publish new articles in order to get tenure! So there's always an incentive to think new things even if they're not that useful. We've seen enough of that in the economics' business. But I think what has been most surprising is that we lulled ourselves into what turned out to be a false sense of security in the idea of the "Great Moderation"—that the types of reasonably severe recessions that we had had earlier in the post-war period—and certainly in the pre-war period—were somehow effectively banned, that henceforth we were going to live in an environment in which, through the careful articulation of economic policy, we wouldn't have recessions like the one we're just going through. And accordingly, people saw the environment as much less risky. When you see the environment is much less risky, you're willing to take actions that, in fact, are a lot more risky. So that kind of false sense of security—which is extended, I think, well beyond the economics' profession and well beyond the financial sector—I think it's part of the story of what went wrong this time. People fundamentally underestimated the degree of risk they were undertaking and it came as a very unpleasant surprise.

Steve Weisman: Are universities catching up and will the next generation learn the lessons of this or not?

Michael Mussa: Certainly important lessons will be learned. I mean, the fundamental principle is once burned, twice shy, so there are going to be lessons that will be learned. How enduring they will be if we're taking it on a 50-year perspective, I think, obviously remains to be seen.

There is a kind of tendency to forget, unless you're periodically reminded by painful episodes, that these things are possible. I think we're not likely to see another one quite like this one for a few years yet. But if we're talking 20 years down the road, then we'll need to see whether we once again lull ourselves into a false sense of security. There's a great short story that I'd like to assign to my classes on this issue, perhaps the greatest short story in science fiction ever written by Isaac Asimov.

Steve Weisman: I was wondering if he would be the author...

Michael Mussa: It's titled "Nightfall."

Steve Weisman: And you're going to leave us with that?

Michael Mussa: It's a story of a planet that has two suns and it's only once every 10,000 years that both of them are on the same side of the planet so they actually have darkness. And the story is that basically people are panicked by the dark. So it's a kind of primordial notion that we're all scared of the dark. And here you have a world where people have never experienced the dark except once in 10,000 years. And even though they know it's coming there's nevertheless an enormous panic in which they destroy existing civilizations regularly each 10,000 years.

And there is, I think, a message there that when you're used to nightfall occurring once a day—once a day is once every 24 hours—it's not quite so disturbing. You know that it will be daylight again fairly soon. But if it's an infrequent occurrence, then people may panic. And I think that's part of what happened on this occasion. There have been many years since we had such a deep and disturbing economic and financial crisis and when the crisis became very intense, people lost it.

Steve Weisman: Mike, let's have you back in sooner than in 20 years. Thanks very much.

Michael Mussa: You're welcome.

