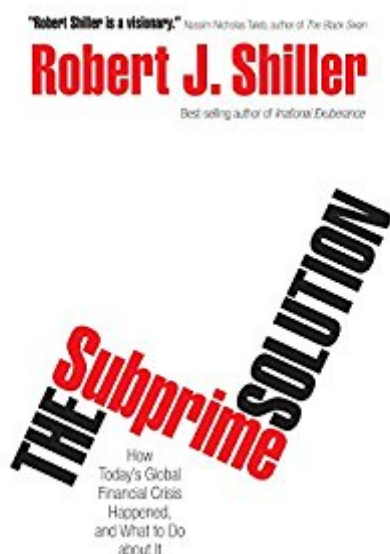


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The Subprime Solution: How Today's Global Financial Crisis Happened, And What To Do About It



Synopsis

The subprime mortgage crisis has already wreaked havoc on the lives of millions of people and now it threatens to derail the U.S. economy and economies around the world. In this trenchant book, best-selling economist Robert Shiller reveals the origins of this crisis and puts forward bold measures to solve it. He calls for an aggressive response--a restructuring of the institutional foundations of the financial system that will not only allow people once again to buy and sell homes with confidence, but will create the conditions for greater prosperity in America and throughout the deeply interconnected world economy. Shiller blames the subprime crisis on the irrational exuberance that drove the economy's two most recent bubbles--in stocks in the 1990s and in housing between 2000 and 2007. He shows how these bubbles led to the dangerous overextension of credit now resulting in foreclosures, bankruptcies, and write-offs, as well as a global credit crunch. To restore confidence in the markets, Shiller argues, bailouts are needed in the short run. But he insists that these bailouts must be targeted at low-income victims of subprime deals. In the longer term, the subprime solution will require leaders to revamp the financial framework by deploying an ambitious package of initiatives to inhibit the formation of bubbles and limit risks, including better financial information; simplified legal contracts and regulations; expanded markets for managing risks; home equity insurance policies; income-linked home loans; and new measures to protect consumers against hidden inflationary effects. This powerful book is essential reading for anyone who wants to understand how we got into the subprime mess--and how we can get out. --This text refers to the Hardcover edition.

Book Information

Audible Audio Edition

Listening Length: 4 hours 32 minutes

Program Type: Audiobook

Version: Unabridged

Publisher: Audible Studios

Audible.com Release Date: August 15, 2008

Language: English

ASIN: B001ED17TK

Best Sellers Rank: #213 in Books > Business & Money > Real Estate > Mortgages #238 in Books > Audible Audiobooks > Business & Investing > Economics #841 in Books > Business & Money > Economics > Banks & Banking

Customer Reviews

Professor Shiller is a leading figure in behavioural finance and this book will certainly maintain that prominent position. The book argues that free markets are both the cause and the potential solution to our current woes. In reading the latter part of the book I was constantly reminded of Friedman's "Capitalism and Freedom" with its warning that markets are more than just a great allocative mechanism, but also a engine to disperse political power from a narrow political elite. Many of Shiller's ideas for hedging house price risk have already been taken up (admittedly in a small way) via the Case-Shiller house price index. I think this book, especially in its latter part, can serve as a blue-print for a wider dissemination of "financial democracy" via disability insurance, etc. I have heard it said that the financial crisis has brought out the best of Gordon Brown as Prime Minister. It has certainly produced some of Professor Shiller's finest writing. Let us hope Brown and Shiller do not have cause for further improvement in the near future. William Forbes (Loughborough Business School, England)

In terms of the value, this book would rate three stars for the layman but only 1 for those knowledgeable in the field. During the first approximately 100 pages of this 180 page book, Schiller describes what lead to this debacle and draws analogies between the current situation and past in both the U.S. (i.e., events leading to the Depression, the Savings and Loan crisis leading to the formation of the Resolution Trust Company, etc.) and overseas (i.e., the 1990s bubble bursting in Japan and the Swedish banking sector crises of the 20 years ago). What he describes should be well known by anyone who has had an undergraduate course in U.S. Economic history, reads a sophisticated financial newspaper or magazine (i.e., Financial Times or Economist) and/or is a financial professional. Hence for this group the first 100 pages would have very little value. For layman without this background, however, this knowledge would provide good perspective. Where the book really is weak, though, is the remaining 80 pages where Schiller provides his "solution(s)". This is what he calls the "democratization" of the financial market. The important points of this consist of: a) The provision of financial advice to "the masses" through subsidized professional financial advice. b) Adding more "bite" to government regulatory bodies (i.e., SEC). c) the creation and utilization of financial instruments that provide insurance against fluctuations in home prices, economic conditions and personal economic conditions (i.e., unemployment). Examples of such financial instruments provided by Schiller include options and futures indexed to housing prices, Government debt instruments that are counter cyclical and instruments that provide the ability to hedge against personal financial circumstances. Each of the above need to be examined in detail.

With respect to the first, it seems highly unlikely that high quality professional financial advisement services that are unbiased (i.e., don't provide advice geared to selling financial products that do not necessarily correspond to individuals' economic situations as opposed to the commissions of the financial advisors) can be provided at a cost effective price that even the lower income ranks can afford. Any such labor intensive service can only be provided (in general), cost effectively, by those with limited educations and/or poorly trained backgrounds. A good analogy would be going to H&R Block. You pay relatively little there but you end up with high school graduates who, in general, have very limited qualifications. The end result would be mediocre advice. In a recent article in the New York Times the IRS was quoted as stating that 2/3 of tax forms prepared by tax preparation firms had contained errors. If these firms cannot succeed in providing relatively simple tax assistance how can they provide more complicated financial advice on how to hedge home, retirement and other assets? Even if they were all highly qualified this would still be a problem. The events leading to the current bubble bursting, as well as those of the late 1990s, caught many highly educated professionals such as Alan Greenspan and Bernanke by surprise. If they failed how can the less qualified be expected to perform better? This simply does not seem logical. With respect to Schiller's recommendation to beef up government regulatory agencies such as the SEC, this would seem the most feasible of all. SEC funding can be increased, penalties increased, and litigation can be loosened to permit an increased deterrence of corporate malfeasance by accounting, investment banks and other financial institutions. This recommendation is very realistic. Schiller's third recommendation, the utilization of financial instruments to mitigate against fluctuations in housing prices and individual economic circumstances, sounds very nice theoretically but is hard to achieve in reality. With respect to housing price fluctuations, options futures on housing prices can be used (they already exist) but they require extensive knowledge in finance and they are relatively expensive to purchase when housing prices are on the decline (when they are needed most). Hence not a solution that seems very practical beyond homebuilding conglomerates. But even they did not make very extensive use of them. With respect to financial instruments that can be used to mitigate against individuals' economic fluctuations (i.e., unemployment) there are other problems. First they do not exist. Secondly, even if they did (and why they are not provided by the private sector to begin with), there would be too much of a problem relating to moral hazard. Individuals can purchase such insurance then either intentionally put themselves out of work or not do enough to prevent unemployment. If one has insurance against all (or nearly all) income losses stemming from unemployment the incentive would greatly decrease to take steps to prevent unemployment. In short, only Schiller's recommendation to beef up regulatory agencies seem realistic and feasible (at

least in the foreseeable future).

Karl Marx, who burned many a late-night candle in the study of historical dynamics, once said "Hegel remarks somewhere that all great world-historic facts and personages appear twice. He forgot to add: The first time as tragedy, the second time as farce." That may have been true a couple of centuries ago, but a more current assessment might be "No matter how much you have learned from history, and however well you have corrected your historical faults, there are plenty more new, and equally treacherous, mistakes to be made in the future." The current financial crisis seems to bear this out. Keynesian aggregate demand management appeared to have died in the stagflation of the 1980's, not because its "rational expectations" critics had a better theory (I think rational expectations theory is just a sick joke), but because of the basic correctness of Milton Friedman's insight that legislative counter-cyclical policy is just too slow to deal with the business cycle. Now, it appears we are all Keynesians (indeed, Republicans have been especially Keynesian in the years since Reagan's historic climb to power), and government is moving at virtually lightning speed to prevent the normal operation of the business cycle. Richard Nixon was wrong when he said, "We are all Keynesians now," but now, almost forty years later, it appears to be true. Who would ever have expected this turn of events? Where are the infamous "rational expectations" theorists now? Doubtless they are holed up somewhere with the Nobel prizes and endowed chairs, laughing all the way to the bank. I think we can confidently say is that if people learn from history, it is only the past ten years or so of history. I was personally blown away when I read Alan Greenspan, who had presided over the Federal Reserve for some nineteen years, admitted to Congress last October that "Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity -- myself especially---are in a state of shocked disbelief." I hope Greenspan is simply lying, but I have a deep fear that he is telling the truth. Some people did foresee the subprime mortgage crisis and predicted an ensuing financial meltdown, among them Edward Gramlich (Subprime Mortgages: America's Latest Boom and Bust, Urban Institute Press, 2007) and Robert Shiller, who coined the phrase "irrational exuberance"---adopted by Greenspan to dampen a recent stock market run-up. This book is a bit of "I told you so," as Shiller makes it clear at every turn that he predicted this a long time ago, so he must be listened to now in attempting to find a solution. The logic isn't there, but Shiller's suggestions are useful and interesting. Shiller believes the subprime crisis is a case of a financial panic, or "bubble," of a sort that has recurred periodically since the dawn of international financial markets (Charles Kindleberger, "Manias, Panics and Crashes," 2000). In the current case, housing prices began a steady increase in about 1999, and by

2004 or so, supposedly intelligent people began to think that housing prices had an inexorable tendency to increase at what we would not consider to be a virtually astronomical rate. Therefore, lending institutions dropped their lending requirements for new mortgages, on the grounds that in a couple of years or so increasing property values would ensure the integrity of the financial asset whether or not the current mortgagee was delinquent. From this point on, in a world-wide financial sector most of whose members, like Greenspan, could not conceive of basic market failures, the melt-down was quite inevitable. There are many things I do not understand about the current crisis, the most critical being why so few financial analysts sounded the warning, and why it was not heeded by level-headed guys in policy positions. I certainly saw it coming, and sold two primary residences in 2006 (on behalf of family members whose finances I managed) at the top of the market. I would have sold them two years earlier if I could have convinced their owners of the madness of holding on to these bubble assets. Shiller's recommendations are well-meaning and worthy of support. His concept of "democratization of finance," so that financial institutions work for all of us, not just the very rich, is brilliant and fecund. If Shiller had his way, people would be as knowledgeable in financial affairs as they are in politics, health care, and other areas in which informed voters and consumers can really make a difference. Each and every one of Shiller's suggestions is worthy of support. First, he says, the financial information infrastructure should be extended to all citizens, much as health care information is (at least ideally) today. Second, financial instruments should be created to deal with the major risk factors faced by the non-wealthy (e.g., variations in house value, price and wage levels). Third, there should be a "default" set of basic financial contracts that non-knowledgeable consumers can use to deal with their most important investments, including home ownership and retirement. In fact, we still do not really understand the causes of the current financial crisis, and we may not for many years. Economists are still debating the causes of the Great Depression, some seventy-five years later (although there is more agreement now than in previous decades). Certainly, more regulation of financial innovation is needed, but in fact, whatever SEC regulations are created, in the next great upsurge of economic activity there will be more financial innovation that slips under the regulatory radar, smart people will make a lot of money and get out while the getting is good, and industry leaders will act as though the new bubble will last forever, or at least for another year (every year). Some new Greenspan-clone will be frankly "shocked" that markets don't work perfectly, and history will repeat itself, not in Hegel's or Marx's sense, but in a perennial tragicomedy that characterizes financial dynamics. Shiller is very supportive of "behavioral finance" in this book, recognizing that people do not have completely objective theories of how financial markets operate, or even of probability

theory basics. He is wrong, however, if he thinks that a strong "financial information infrastructure" will change this. People with crazy theories of probability and risk cannot be taught otherwise---I know because I have tried. I have tried to tell day-traders that they are enriching only their brokers, and they will be out of business in nine months (the median life of a day trader, I am told). I have tried to convince testosterone-endowed relatives that, whatever happens in James Bond movies, luck is not with the sly, the muscular, or the devout. All to no avail. Some will say that we should suppress the whole dynamic that gives rise to financial innovation and bubbles. We should always lend a critical and attentive ear to such proposals, but we must always recognize that the vitality of our economic system depends on financial innovation, and we should always appreciate those people who ignore history and stick their necks out to make new history. They go where angels (and "progressive" political critics) fear to tread, and we are the better for it.

I am not sure I agree with all of Shiller's proposals but his analysis is absolutely first rate. He describes in great detail how we got into the subprime mess. Unfortunately, I am not sure that many politicians have read the book - they should.

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