

# Economic Lessons from the 08-09 Financial Crisis

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International Risk Management Conference

Jerusalem

13.6.2016

# Understanding the Crisis

Failure of Market Economics?

Failure of Economic Theory?

Behavioral Economics?

**No!**

Good old Neoclassical Economics:

# Incentives

# Immediate Cause: **Subprime Lending**

- Easy borrowing created high demand for housing
- This demand was met by a lot of new construction
- Then defaults created a housing glut, so prices dropped
- Low down payments gave **incentives** to default
- This drove prices even further down
- The process continues ...

# Underlying Causes:

- Overleveraging
- Entanglement (insurance – credit default swaps)
- Correlation (everyone doing the same kind of loans)
- **Incentives** for Bank Managers

# Lessons

- Executive compensation:
  - provide the right structure
- Avoid Bailouts
- Regulate sparingly
- Avoid Entanglements

# Executive Compensation

- To create proper **incentives**, executive bonuses should be in *stock*, **not** *stock options*.

# Bailouts

Bailouts – of nations as well as corporations – have **short-term** benefits, but create negative **incentives**

- for the managers of the corporations,
  - for the creditors of the corporations,
  - for the leaders of the countries,
  - for the citizens of the countries, and
  - for the creditors of the countries;
- and so, have unfortunate **long-term** effects.

# Regulation

- Should be held to a minimum, as it
  - discourages business, and
  - creates **incentives** for corruption.
- One **should** regulate **only** for:
  - honesty and transparency,
  - health and safety, and
  - maintaining **competition**.
- One should **not** regulate:
  - Executive Compensation,
  - Risk Taking,
  - Interest Rates,
  - ...



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Thank You