The Incompetence Hypothesis to Explain the Great Recession

by Susanne Trimbath 07/31/2015

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Seeking an understanding of the Great Recession, I am finding that most of the 2008 financial crisis and its aftermath can be explained by incompetence. In the final weeks of writing a book on the systemic failure in US capital markets, I had to re-read the Securities and Exchange Commission (SEC) Inspector General's 2009 report on their failure to stop Bernard Madoff despite having received credible evidence of a Ponzi scheme. The inspector concluded that it did not have anything to do with the fact that an SEC assistant director was dating (and later married) Madoff's niece; or that Madoff had held a Board seats at important financial regulators.* Despite eight substantive complaints and two academic journal research reports over 16.5 years about problems with Madoff's investments, Madoff was never caught. In the end he turned himself in, admitting to a $64 billion Ponzi scheme. The inspector's conclusion: incompetence.

In economics, 'interest' – whether it be self-interest or interest group pressure – is the 'safe' explanation for outcomes that are detrimental to the public. If interest group pressure (or even populism) is behind a bad policy decision, then it is not a 'mistake.' Rather, it is an intentional, rational decision as described by Chicago School economist and Nobel laureate George Stigler. However, if a policy decision is the result of bad judgment, then Stigler cannot explain it. Brazilian economist Luiz Carlos Bresser-Pereira suggests that the relevant variable in this case is incompetence. Incompetence is an independent explanatory variable; it cannot be explained in rational or historical terms.

Incompetence arises from three sources: 1) ignorance, 2) arrogance, or 3) fear. Policy advisors and regulators may be guilty of applying theories second-hand but with great authority and self confidence. They may be ignorant of the complexities of economic theory and they may apply abstract economic theories inappropriately to specific policy problems. For example, they allowed banks to engage in a wide range of investments under the financial theory of 'diversification.' That theory works for portfolios but not for businesses, which need to specialize to realize the gains from their comparative advantage. Financially derived theories like this were applied automatically, transformed into a series of clichés.

'Diversification' in a portfolio of financial investments lets you increase the returns while reducing the risk. But in business it means 'splintering' which destroys performance capacity and increases risk. Financial institutions are tools to be used in furthering the efforts of the broad economy: the more specialized financial institutions become, the greater their performance capacity. Increased productivity from specialization comes with better quality as businesses become more adept at their specific products and services. The differences in natural aptitudes and abilities produce economic benefits when tasks are matched to capabilities. The more experience a worker has at performing a task, they more efficient they become in doing the work. As management guru Peter Drucker wrote: 'Organizations can only do damage to themselves and to society if they tackle tasks that are beyond their specialized competence.'

An example of an economic theory applied arrogantly is Washington's constant fawning over 'free market solutions' when the rules, regulations and court decisions covering capital markets fill the bookshelves of law offices around the world. There is no such thing as a free market – no economist of value believes that the perfectly competitive market exists. The Wall Street Bailout is a good example of the third source of incompetence – fear. Consider this description of the exchange between Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke and the senior legislators from the House and Senate on Thursday, September 18, 2008:

Sen. CHRISTOPHER DODD: Sitting in that room with Hank Paulson saying to us in very measured tones, no hyperbole, no excessive adjectives, that, "Unless you act, the financial system of this country and the world will melt down in a matter of days. "

JOE NOCERA: Bernanke said, "If we don't do this tomorrow, we won't have an economy on Monday."

Sen. CHRISTOPHER DODD: There was literally a pause in that room where the oxygen left.

Inside the Meltdown, Frontline February 17, 2009, WGBH Educational Foundation, Boston.

Regardless of the source of the incompetence, the visible results are 1) failure to take correct strategic policy decisions, and 2) failure to adopt well-designed reforms.

Policy decisions are the day-to-day management decisions that usually produce immediate results. In monetary policy, for example, these would be interest rate decisions. Interest rate policy decisions need to be made at the right time and to move rates in the right direction.

Reforms produce medium-term outcomes that may or may not require legislative approval. The Dodd-Frank Act, which was supposed to reform Wall Street and protect Main Street, in reality created very little change but suggested that financial regulators reform their own rules. Poor reforms may be the result of incompetent designs and not just pressure from interest groups, although this also happens.

Bresser-Pereira's analysis offers one more alternative explanation for the cause of bad policy and reforms. Between interest and incompetence lies 'confidence building.' It is simply doing what is expected in an effort to gain the confidence of financial supporters. If we substitute "Goldman Sachs" for "United States" and "Wall Street" for "developed countries" in this quote from Bresser-Pereira, then his description of 'confidence building' is as true of Washington, D.C. as it is of Brazil:

'They do not limit themselves to seeing the United States and, more broadly, the developed countries, as richer and more powerful nations, whose political institutions and scientific and technological development should be imitated. No, they see the elites in the developed countries both as the source of truth and as natural leaders to be followed. This subordinate internationalism ideology, already called 'colonial inferiority complex' and *entreguismo***, is as detrimental to a country as old-time nationalism. What I am singling out as a major source of incompetent macroeconomic policies is the uncritical adoption of developed countries' recommendations.'

If we say that bad policy decisions are always rational, motivated by interest, then we must conclude that policy-makers are 'dishonest, protecting their own interest or those of their constituencies rather than the public interest' (Bresser-Pereira). If this view were always true, then the world would look more like communist Russia in 1980 than the way it does today. How would entrepreneurs and consumers have financed not only the invention but the proliferation of microchips, cell phones, and personal computers that have made the world safer and easier to navigate; how would they have discovered and made widely available artificial hearts, HIV medications and targeted cancer therapies? Since 1981, the number of poor people in the world declined for the first time in history, by 375 million. Global life expectancy was 68 in 2014, up from 61 in 1980; infant mortality is down to 49.4 per 1000 live births in 2014 from 80 in 1980. Yet as a result of the havoc wrecked upon the global economy in 2008 by incompetent regulators, policy makers and bankers, global unemployment grew from 20 to 50 million while falling incomes combined with rising food prices to raise the number of undernourished people in the world by 11%.

A solution, from this perspective, lies in cleaning house of the incompetent staff from Washington to Wall Street and improving recruiting methods to build competence for the future.

* Madoff has a seat on the Board of the International Securities Clearing Corporation, one of the predecessor organizations to the Depository Trust and Clearing Corporation, the world's largest post-trade processing center. Madoff was also Chairman of the NASDAQ, and had seats on the Boards at the National Association of Securities Dealers (now the Financial Industry Regulatory Authority – the same organization that failed to act on a referral letter from the SEC to stop R. Allen Stanford's Ponzi scheme.

**Brazilian Portguese roughly translated as 'appeasement' or 'submission.'

For more information:

Luiz Carlos Bresser-Pereira, Latin America's quasi-stagnation, in A *Post Keynesian Perspective on 21st Century Economic Problems*, Elgar, UK. http://www.bresserpereira.org.br/

The World Factbook 2013-14. Washington, DC: Central Intelligence Agency, 2013.

https://www.cia.gov/library/publications/the-world-factbook/index.html

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