BOOK REVIEWS

The New Financial Order: Risk in the 21st Century
Robert J. Shiller
Princeton and Oxford: Princeton University Press, 2003, 366 pp.

The New Financial Order presents a vision of a radically new world of greatly enhanced risk sharing and much greater economic security for us all. It confronts the problem of how to deal with the risks we face, or how to reduce economic insecurity. These risks, large and small, are the downside of capitalism's ongoing process of "creative destruction." They have hampered economic progress throughout history, and have been the source of countless foregone opportunities and untold misery. This book proposes a new framework to handle these risks, and so protect people against them. As such, it will encourage more positive risk-taking behavior, better development and use of individual skills, and greater personal fulfillment. As Shiller notes, he wishes to "democratize" finance and "bring the [risk-management] advantages enjoyed by the clients of Wall Street to the customers of Wal-Mart" (p. 1). Implementing this vision involves a huge extension of risk-trading activity, and the establishment of a global infrastructure to measure and manage the risks involved.

The New Financial Order provides an insightful, and in many ways appealing, perspective on the process of economic development, with discussions on a great range of diverse topics. The book is divided into five parts. Part 1 looks at the many different types of risks we face, the factors that give rise to them, and the damage they can do. Part 2 examines how science and technology create new economic opportunities and new risks. It also looks at the psychology of risk perception (focusing especially on risk-framing issues and the work of Daniel Kahneman and Amos Tversky) and the nature of invention. Part 3 outlines Shiller's six core proposals (of which more below), and part 4 looks at "deploying" the new financial order: the use of new units of measurement, the problems involved in establishing international data-base systems to underpin risk-trading activity, the difficulties faced by financial and political reformers, and research into, and advocacy of, the new financial order itself. Finally, part 5 looks at the new financial order as the continuation of an ongoing

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historical process, and looks at the lessons to be drawn from the major financial and social insurance innovations of the past.

The essence of the new financial order is to be found in Shiller's six core proposals. The first of these is to extend the purview of insurance to cover long-term economic risks, leading to livelihood insurance to protect income and to a more radical form of home insurance to protect the economic value of the home (and not just to protect against specific risks such as fire risk). The second is to establish macromarkets: large international markets trading long-term claims on national income or gross domestic product, occupational income, real estate prices, and various other risky variables, including world GDP. (One could also envisage other macromarkets that Shiller does not explicitly discuss: for example, insurance companies and pension funds could share mortality risk by means of mortality swaps.) The scale of these macromarkets would be massive and dwarf anything yet seen. The third is for banks and other financial institutions to offer income-linked loans to enable people to sell shares in their future incomes and hedge income-related risk, and so avoid the hardship and other problems that many borrowers currently face. The fourth idea is inequality insurance, which is designed to ensure that income inequality within a nation does not increase. This proposal involves reframing the progressive income tax structure so that tax brackets are automatically adjusted to fix the amount of inequality over time. The fifth idea is "intergenerational social security," which involves reframing social security to ensure "genuine and complete" intergenerational risk sharing. This proposal is intended to go well beyond existing systems of "social security" and the informal and limited intergenerational risk sharing that currently takes place within families: it boils down to the idea that everyone gets a fixed proportion of the available income, so we all share in the current state of the economy, good or bad. The last idea is a set of international agreements between different nations to share risks on an international intergovernmental basis. These deals would resemble private agreements, but go well beyond them in scope and horizon. For example, the governments of two countries might agree to pool their economic growth risk, so that if one country enjoys a higher than expected growth rate, and the other suffers a growth rate less than expected, then the government of the former country would make large transfers to the government of the latter.

Looking at this book from a financial economics perspective, the primary driving force behind Shiller's thesis is the potential gain to be obtained from increased risk sharing: his message is that the potential gains from further risk sharing are enormous. I am inclined to agree with him, up to a point, but I also believe that Shiller tends to overestimate those gains because he underestimates some of the obstacles to increased risk sharing.

The issues involved are perhaps best understood in the context of one of his examples. Consider a young woman from India who wishes to

become a violinist. She is worried about borrowing the money for her training because of the uncertainty of her future income as a musician. The solution, argues Shiller, is for her to take out a loan, whose repayments are contingent on the future incomes of professional violinists. Should the market for violinists subsequently go down, her loan repayments would go down as well. Her risk exposure would be substantially reduced, and a substantial proportion of her career risk would be transferred to portfolio investors all over the world. She would then be in a much better position to accept the risk in the first place and, hence, to realize her ambitions.

Maybe, but examples such as this one beg some awkward problems. One of these is the problem of credit or default risk: the amount this one party will entrust to another will usually depend on the guarantees that the debtor party can provide, such as collateral. Limitations on effective collateral will inevitably limit the amount that the lender will provide. If the young woman cannot provide credible reassurance to prospective lenders, then perhaps a loan (of any sort) might not be economically feasible, and the "optimal" solution may be for her to consider a different career. Furthermore, even if a loan is to be made, there are often good reasons why it might take the time-honored form of conventional debt with costly bankruptcy: verification costs might be lower, the lender might have reasons to prefer fixed repayments, and so forth. There is also the related problem of moral hazard, which exists even if the loan repayments are contingent on a group-income index that is beyond the control of the debtor. This is because the debtor still has the option to default—and the problem of possible nonrepayment does not go away (although it might be mitigated) even if bankruptcy laws are amended to prevent debt forgiveness. There are many promising-looking gains from risk sharing that turn out not to be feasible when one takes account of collateral and moral hazard problems—as well as imperfect information, transactions costs, and other "imperfections."

Another problem is that there have been many new derivatives contracts that appeared to offer attractive risk-sharing possibilities, but those failed to take off for one reason or another. A high proportion of new derivatives contracts offered by organized exchanges fail to generate any significant trading and are subsequently withdrawn. A notable example was the CPI futures contract traded for a short period in the mid-1980s on the Coffee, Cocoa, and Sugar Exchange in New York: this is exactly the kind of macromarket that Shiller envisages, but trading was so thin that the Exchange eventually closed it down. New contracts fail for many reasons that are still not well understood, but one of the most important reasons for failure appears to be the inability of prospective users to find a suitable hedge. There are many institutions that would trade new contracts if they could hedge the risks involved, but would shy away from such contracts if they were unable to hedge them effectively. This is especially a problem with contracts involving long-term risk ex-

posures, as would be the case with many of the derivatives envisaged by Shiller.

A third obstacle is legal risk: the risk that the relevant legal systems will fail to enforce contracts after they have been entered into. Legal risks are major obstacles to successful risk sharing, and manifest themselves in many ways. To give a straightforward example, individuals who buy retail insurance contracts need to have reasonable confidence that their contracts are sold in good faith and will be honored, and yet the behavior of insurance companies toward their clients often suggests that such confidence is misplaced. For instance, over the last decade or so, the British insurance industry—allegedly one of the best ones in the world—has been implicated in a series of scandals on a massive scale, involving the mis-selling and mismanagement of personal pensions, endowment mortgages, health and unemployment insurance, and other financial products. The number of victims runs into the millions, and relatively few of these have had (or are likely to get) any effective legal redress, due to the inadequacies of the British legal and financial regulatory systems. Not surprisingly, public confidence in the competence and integrity of the British insurance industry has reached an all-time low, and even "good" products are now unlikely to sell for a long time. One shudders to think what the public would have to put up with in other countries.

Another aspect of legal risk is the vexing problem of sovereign risk—that is, the risk of default by sovereign counterparties. This risk has always been a problem for international lending arrangements, and is likely to be a very major obstacle for the scale of potential transfers Shiller envisages. For example, Shiller discusses how Argentina and South Korea might have agreed to a real GDP swap in 1965, when Argentina was a relatively rich country and South Korea a relatively poor one. Shiller claims that they would both have been better off in 1965 by sharing their relative economic performance risks. Since then, Argentina's real per capita GDP has fallen, whereas South Korea's has risen by more than 500 percent, so South Korea would have ended up paying a very substantial proportion of its GDP as a transfer to Argentina. The problem with this proposal is manifestly obvious: South Korea would have faced a huge incentive to renege on the deal, and there would be nothing that Argentina could do about it. The credibility of such arrangements is therefore very low, and likely to remain so. As an aside, I would also note that there is nothing to stop South Korean and Argentine *firms and individuals* from trading risk. For instance, they might engage in equity swaps, whereby the South Koreans would make payments to the Argentines if the South Korean stock market does better than the Argentine one, and vice versa. Equity swaps have been around for years, and have the advantage over Shiller's sovereign GDP swaps in that an aggrieved party can seek effective redress in the courts.

We can also review Shiller's book from a political philosophy perspective. He specifically rejects the idea that his proposals are motivated by any specific political *ideology*. However, he does have certain clear *views* on political philosophy: a Rawlsian "veil of ignorance" approach to social risks, a belief in the legitimacy of most governmental institutions and their ability to create and/or reflect a social consensus, and a keen awareness of the importance of "framing" issues (i.e., that the answers we give as risk-taking individuals can depend on how the risky alternatives are put to us). What is *not* here is any strong emphasis on property rights or what those rights entail in terms of limitations on government power, including tax-raising power, and Shiller believes that his extensive international risk-management infrastructure can be established in tandem with existing governmental institutions.

I am not convinced. Without going into deeper issues of how to protect individual rights (including the right to privacy), the type of constitutional reform that would (might?) be required, and so forth, I think some of his more radical proposals would clearly not fit in well with existing governmental arrangements. For instance, it is difficult to believe that any country would have the political ability to deliver large payouts on the author's proposed international GDP swaps if it were "lucky" enough to become more prosperous than its counterparty country. To revisit our earlier example, can one seriously imagine South Korean politicians being able to persuade their electorate that they should hand nearly half of their GDP to the government of Argentina, *whatever* promises they might have made to Argentina in the past? Can one really imagine South Korean voters taking the view that they should hand over the fruits of their labor to compensate their "unlucky" counterparts in Argentina—as if their greater relative prosperity had nothing to do with their own hard work or the Argentine government's chronic economic mismanagement? The scale of the transfers would dwarf the infamous reparations imposed on Germany after the Treaty of Versailles, and which ended up paying the victorious Allies next to nothing anyway. Looking at these arrangements from an economic constitutional perspective, they also involve giving governments most of their countries' GDPs, even *before* we start talking about the financing of any domestic programs such as education, defense, transport systems, and the like. The potential tax disincentive effects would be unthinkable, and the political and constitutional implications are enormous.

Likewise, Shiller's proposal for inequality insurance to freeze existing levels of inequality also raises deeper issues (e.g., what is so sacrosanct about existing inequality that we should aim to freeze it indefinitely?), and I don't share his confidence that the disincentive effects will be fairly small, that suitable "framing" will lead to a public consensus that accepts its fairness, and so on. Establishing inequality insurance would involve a major overhaul of the whole fiscal (or tax-benefit) system, may not even be technically or economically feasible, and would give public-sector

economists nightmares for years to come: changing any existing income-based tax systems—all of which are already monstrously arcane—to an inequality-based system would constitute a truly radical (and unprecedented) fiscal reform, with all kinds of unforeseen consequences.

Finally, similar objections can be made about Shiller's proposal for intergenerational social security. There is no consensus to drive it; its feasibility is doubtful; and it would involve a radical fiscal reform with major disincentive and other negative side effects. In any case, it is far from clear that many people would regard it as fair in the first place. Why is it "fair" that everyone should have a fixed proportionate claim on national income, regardless of circumstances, previous contractual promises, and anything else? For example, why should a retired couple regard it as "fair" that their income gets cut in a recession if they have a defined-benefit pension scheme that promised them a certain fixed income, or if they have saved all their lives precisely to protect their retirement income? Why shouldn't younger people take a disproportionate "hit" in a recession in the traditional way: after all, most of them haven't saved, have their lives ahead of them, and don't have the medical bills to worry about? The "fairness" of "intergenerational social security" is not nearly as obvious as Shiller suggests.

So how likely are we to see the new financial order that Shiller envisions? I think the answer depends on which elements of his new financial order we are talking about. There is clearly scope for some forms of livelihood insurance and home equity insurance, and for some forms of "macro" risk sharing, such as trading on property indexes. There may also be scope for some forms of income-linked lending, although these latter arrangements in particular have some major obstacles to overcome. The logic of macromarkets is sound, although I think some of these will be more difficult to establish and take longer—and there will be more false starts and failures along the way—than Shiller seems to suggest.

I am very doubtful about Shiller's more utopian schemes—for inequality insurance, for his vision of "intergenerational social security," and for intergovernmental risk sharing on a very large scale. These schemes would require a radical overhaul of existing governmental institutions, and possibly even—heaven forefend—a world government. Instead, future progress in risk sharing is likely to mirror its past: it will be driven by private rather than governmental initiatives, with government usually tending to be a hindrance rather than a help (in imposing often useless regulatory burdens, in failing to provide or allow effective redress through the courts, etc.). But in the final analysis, human progress is full of surprises, and perhaps the only safe prediction is that the future is likely to be very different from what any of us can foresee—history will have the final say, as it always does.

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