

The Economic Importance of Being Educated

INSIDE:

Early Childhood Education

Consumer Finance

Mortgage Counseling

PLUS:

Q&A with Laurence Meyer

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



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FALL 2010

Volume 1 Number 3

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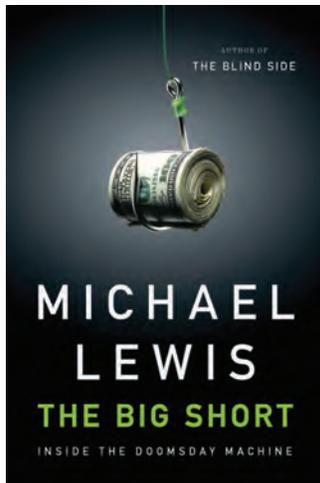
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Book Review



The Big Short: Inside the Doomsday Machine

by Michael Lewis
Norton 2010



Reviewed by
Dan Littman,
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In the past year, at least 20 books on the financial crisis have crossed my desk. I have read parts of all of them. Some are excellent—insightful, behind-the-scenes looks at the people and policies that contributed to and then reacted to the crisis. Other books, alas, are not so splendid—way too technical, so inside baseball that they make no sense to the lay reader.

So if you are only now getting around to deciding which tales to read about the financial crisis, I am here to help. A good place to start is *The Big Short: Inside the Doomsday Machine*. Michael Lewis, an editor at *Vanity Fair*, writes a novelistic account of the crisis that follows four hedge fund

managers who predicted the housing market crash as early as 2004. The quartet aggressively took “short” positions on mortgage-backed securities through the purchase of a type of insurance called a credit default swap (CDS). Essentially, they were betting the market would tank, and how right they were.

The protagonists initially met resistance from investors and bankers: Why were they wagering against a market that was seemingly going so well? They also faced difficulty in getting CDSs offered on mortgage-backed securities in the first place. At the time, CDSs were not widely used as insurance against mortgage-backed securities.

Said one of the money managers: “Nobody we talked to had any credible reason to believe the failure of subprime CDOs [collateralized debt obligations] was going to become a big problem; no one was really thinking about it.”

It didn’t take long for the investors to prove their doubters wrong. Their bets against the market would eventually pay off in the form of hundreds of millions of dollars. At the same time, of course, others were losing hundreds of millions with the tailspins of Bear Stearns, Lehman Brothers, Freddie Mac and Fannie Mae, and AIG.

The Big Short is strong in conveying the drama in the midst of the crisis. And it is so effective at telling the human story that the “hard stuff” is much easier to understand than in other texts. Lewis excels in explaining the complicated investment strategies of those buying mortgage-backed securities and selling CDSs, and, conversely, those buying CDSs and shorting mortgage investments. On top of it all, Lewis is effective in describing the often complex and arcane investment instruments themselves. Readers will learn a lot from reliving the crisis from an insider’s point of view.

Yet *The Big Short* is not a perfect book. While Lewis provides important evidence about what happened in the run-up to the financial crisis, he is not terribly helpful in explaining the underlying historical forces in housing, finance, and government policy that brought us to the brink. Nor is his book deep in discussing the effectiveness of the immediate policy response in the context of other choices the Federal Reserve, the Treasury, and others had available.

Translating the dramatic action in *The Big Short* to how regulators ought to change their behavior and their rules to forestall a future crisis requires wider reading of the available literature.

With that in mind, here are some other good books you might consider to fill out your knowledge about the financial crisis:

- Gillian Tett, *Fool’s Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe*. Tett, the U.S. editor of the *Financial Times*, summarizes how the credit default swap was “invented” and how it evolved to become a key contributor to the financial crisis.
- Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*. The authors—both economists—provide a rigorous and indispensable historical perspective on the recent crisis.
- Sebastian Mallaby, *More Money Than God: Hedge Funds and the Making of a New Elite*. The hedge fund industry is the focus of this author, an official at the Council on Foreign Relations.
- David Wessel, *In Fed We Trust: Ben Bernanke’s War on the Great Panic*. Wessel, economics editor at the *Wall Street Journal*, delivers a fly-on-the-wall account of Federal Reserve actions during the financial crisis. ■