The New Financial Order

The New Financial Order: Risk in the 21st Century. By Robert J. Shiller. Princeton, NJ: Princeton University Press, 2003. Pp. xvi, 366. $29.95.

Combining institutional description with exhortation, this is an ambitious book that will attract wide attention and may prove to be very influential. Robert Shiller seeks to convince the reader that ongoing developments in market institutions and technology are creating a New Financial Order in which risk will be far better managed—i.e., diffused more widely—than heretofore, leading both to a (great) reduction in economic insecurity and an associated increase in willingness to participate in risk bearing.

Although he does not put it this way, Shiller is proposing to augment previous explanations of economic growth by highlighting willingness to bear risk as a primary determinant. Throughout the book but especially in Part 5 ("The New Financial Order as a Continuation of a Historical Process") Shiller argues as though the history of financial institutions has been the outcome of a continuing struggle between clear-sighted innovators and unimaginative resisters of change. Although from time to time he gives perfunctory recognition to the mishaps of innovative processes, he does not give much credit to the unheralded perceptive skeptics who, by refusing to accept faulty innovations—especially in finance (e.g., Ponzi schemes)—have cleared the way for the better quality survivors that Shiller seeks to emulate.

But only rarely does a balanced historical account accompany confident advocacy of a particular course of action. Shiller's confidence that a New Financial Order is coming is based on extrapolation of recent developments in computer technology that facilitate storage retrieval and analysis of vast quantities of information about the characteristics and life histories of entire populations of individuals and nonhuman assets.

Although Shiller recognizes the current absence of effective demand for the various insurance products whose appearance he foresees, such recognition does not deter him. Drawing on a particular view of popular psychology (chapter 6), he contends that most people do not appreciate the possibilities inherent in unfamiliar technologies and institutions and belatedly come to accept them only through imitation of the imaginative few. As a result, the process of initiation is difficult and attended with many failures, serving both to explain and justify the high rewards of the few who sponsor successful outcomes. This is a familiar story and Shiller does not dwell upon it beyond presenting a few good examples, both in finance and elsewhere, to illustrate the point that innovations in capability of supply and recognition of potential utility are often symbiotic, so that successful entrepreneurship requires both creation of a novel product and demonstrating a need for it. However, Shiller's story is essentially one in which demand lags supply.

One important instance of lagging demand is the (largely unrecognized) need for and possibility of insuring against the risk that adverse economic conditions will affect the value of a household's long-term investments. To remedy this Shiller proposes Livelihood Insurance and Home Equity Insurance. In choosing a specific occupation or career plan to which she will be committed for a substantial part of her life, an individual undertakes a great economic risk. To a lesser—though still substantial—degree a similar statement holds for the purchase of a home. Shiller contends that although there is a great potential demand for insurance against these risks, this demand is not presently manifested because such insurance is unfamiliar both to (potential) buyers and suppliers.

Although purchase of insurance against loss from physical damage (e.g., fire, flood, earthquake) is very common, insurance against loss in market value of a house because of (say) a decline in local business activity is generally unavailable. An important reason has been moral hazard: if an individual were insured against a major part of a loss of value in her own house, she might be tempted (*inter alia*) to scrimp on maintenance. But this haz-

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ard would be removed if the home owner were insured against a decline in the value of the *average* house in her local area. Until recently a major obstacle to such insurance has been lack of area-specific indices of the value of existing homes. However, within the past decade or so, this difficulty has been considerably reduced—in good part through the (commercially successful) work of Shiller and his associates. As a result a number of "home equity insurance products" based on housing price indices have been created and marketed for several localities (pp. 119–20).

As Shiller candidly admits: "The efforts to start such futures markets have been uninspiring so far, but we continue in our efforts to encourage futures exchanges to list such contracts" (p. 136). He considers this an example of the inability of people to perceive the risks inherent in long-term financial commitments unless such risks are properly framed. Thus people are far less sensitive to fluctuations in the value of their homes than to comparable fluctuations in their corporate shares. This difference is attributed to the continuous stream of price quotations on shares as compared with the infrequent quotations on the value of comparable houses. Once futures markets for indices of housing values are properly launched, (Shiller contends that) the stream of price quotes will lead people to treat claims to houses as they do stocks and bonds.

Even after discounting for seller's enthusiasm, I consider Shiller's proposal for Home Equity Insurance to be practical as well as ingenious. But Livelihood Insurance is another matter: the idea is to insure individuals embarking upon a career against the risk that their incomes at specified stages of the life cycle might fall below what a person sharing their initial characteristics could reasonably have expected to earn. The concept is a pooling scheme in which the annual premiums and benefits of a given individual will vary with the average income of persons sharing her characteristics. The outcome envisaged is transfer of income from individuals who earn more than the average of those in their particular "characteristics class" to individuals who earn less than the average.

There are two basic problems with such schemes: moral hazard and establishing actuarially fair premiums. Shiller is well aware of both. He addresses moral hazard as follows: premiums and benefits to an individuals are not to be based on the level of her own earnings, but on average earnings of *comparable* individuals. A class of comparable individuals would consist of those in the same labor force cohort with the same number of years of schooling, in the same *initial* occupation and health status, and having equal status in respect of as many other identifiable characteristics bearing on prospective earnings as an insurer might identify and measure.

To accomplish their purpose Livelihood Insurance contracts would have to cover all or most of an individual's prospective working life, and therefore insurers would be subject to the risk of adverse selection in cancellations. Persons learning early in their careers that they were likely to earn more than the average would be more likely to cancel their policies than those in the reverse position. To guard against this hazard, policies would have to incorporate clauses imposing suitably high penalties for premature cancellation. *Inter alia*, this might lead to situations in which low earning individuals associated with high earning characteristics were compelled to subsidize substantial payments to those having much higher incomes. The problems that such situations would create hardly need to be elaborated.

But the difficulties of determining actuarially fair premiums are even greater. The information that Shiller (correctly) anticipates an insurer would need in order to draw up livelihood insurance contracts would require access to an enormous set of databases, or GRIDs (global risk information bases). Shiller makes it clear (p. 194) that GRIDs should cover every member of the population. He writes:

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> GRIDSs would provide finely detailed continuously updated, widely available data on incomes and asset prices . . . GRIDs would help risk management contracts respond to date on *individual* people or organization . . . (pp. 189–90) . . . . Associated with . . . individual income data are data on characteristics of the individual . . . date of birth, sex, family structure, and educational and occupational history, possible even genetic information, ... If these are available on a GRID, risk management can take account of some individual characteristics because . . . (they) may signal risks unique to that individual. (pp. 194–94).

Privacy? Not to worry.

> Privacy of individual or firm records can be ensured even while allowing researchers access to their data . . . . One method is dynamic assessment of risk of breach of confidentiality . . . Another method is matrix masking and the addition of noise . . . . Another, more sophisticated method masks micro data using the predictive distribution of confidential data, so that statistical inferences from the masked data should be unaffected by the masking. (p. 192).

While I would welcome this open yet secure world, I fear it will be a long time in coming, and that its arrival is none too certain. The ongoing contest between access-seeking hackers and security-protecting programmers is far from settled at present.

But grant that GRIDs could be constructed to Shiller's specifications. What could they tell a prospective livelihood insurer? Certainly, more detailed information about an individual's personal history, fixed characteristics, and all relevant aspects of her socioeconomic environment would improve the ability of a *given* regression equation to forecast future earnings. But as not much is known about the signal/noise ratio of income-generating processes the extent of the prospective improvement would be very uncertain. Worse yet, availability of Livelihood Insurance would change the historic distribution of choices among more and less risky career options. Indeed, Shiller regards the facilitation of such shifts (toward the more risky options) as one of the major benefits of Livelihood Insurance. However, such shifts would also reduce (to an unknowable extent) the predictive power of information derivable from GRIDs.

To avoid excessive length, I omit comment on several of Shiller's other proposals for private risk-sharing through the action of governments. Although Shiller is fascinated by the possibility of creating private markets in order to implement use of novel instruments of risk sharing, he is also a social reformer who seeks to increase the "general welfare" by spreading risk through actions of government. One of his proposals, Inequality Insurance, is designed to prevent *increases* in the inequality of income distribution by making tax rates applicable to particular income brackets vary from one accounting period to another so as to hold constant the Gini Coefficient of after tax income while collecting the (exogenously determined) aggregate revenue required. (For brevity, I shall ignore ambiguities associated with the possibility that a given Gini Coefficient may correspond to two different income distributions whose Lorenz curves intersect.) Shiller is very specific that his proposal would leave "the extent of inequality at its present levels" (p. 152). He desires this both to preserve incentives for economic achievement and "to prevent inequality from ever expanding so far that it causes the kind of resentment and social conflict seen in the most unequal countries of the world" (p. 164).

One's sympathy with these sentiments is likely to vary with one's feelings about the level of inequality that is to be maintained. This book was (presumably) written before passage of the 2003 (U.S.) Tax Reform, the intent of which was to increase the inequality of after tax income. One wonders whether this legislation would alter Shiller's view that "existing" inequality requires no redress, or whether he believes that any degree of inequality can be made palatable to those disadvantaged or unlucky through some feasible reframing of their perceptions. I would surmise that there is sufficient resentment about existing inequality that,

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combined with the complexities that would attend any specific implementation of Shiller's proposal (he is very short on details), there will be plenty of time to reflect upon its merits.

The problems associated with deciding upon a proper level of distributional inequality also plague another of Shiller's proposed reforms: Intergenerational Social Security. His (justified) concern is that present old age pension formulae (that guarantee specified dollar payments to retirees) tend unjustly to benefit members of larger generations at the expense of members of smaller ones. In essence, Shiller's remedy involves adjusting social security taxes and pension payments so as to make them partially dependent upon the size of one's own (and neighboring) birth cohorts and thereby offset the subsidization of large sized generations by smaller ones.

Such a remedy would be fine if its implementation were delayed (at least) one generation so that lifetime plans of work and saving could be made on the basis of prespecified arrangements for retirement. To institute a sudden adverse change in such arrangements would appear to current retirees and those about to retire as a simple wealth transfer and would be resisted as such. Shiller's failure to recognize this problem conflicts with his very proper concern (e.g., p. 15 and n. 14) with the need for a certain rigidity in institutional arrangements to protect property rights in long-term contracts, particularly the very insurance contracts he is trying to establish. In short, I think the distributional reformer in Shiller who emerges on various pages (notably "The Moral Dimension," pp. 16–17) needs to confront the market extender who dominates the rest of the book. Although his internal conflict may not be insoluble it will need a lot of work, and not least by Shiller himself. But despite this partially suppressed conflict, Shiller is clearly a standard bearer for the "entrepreneurial class." In this role he slants history so as to "accentuate the positive and minimize the negative" aspects of innovation. Thus he remarks:

> . . . financial innovation sometimes encourages secret dealings, deception, and even fraud. Secretive firms such as Long-Term Capital Management have misled investors and then blown up, . . . and unethical firms, such as Enron, have committed malicious fraud that harmed many people . . . . But this should not be viewed as evidence against . . . the field of finance. New technology, with all its power, is always dangerous, ... In the early age of steam, many people were killed by boiler explosions, ... Eventually, technological advances sharply reduced such accidents . . . (p. 14).

While he has a point, he should have added that regulations designed to hold innovative processes within "socially acceptable" bounds have played an important though much disputed role in the reductions of "such accidents" and not least in the field of finance. The interface of such regulations with Shiller's various risk-sharing proposals would constitute a valuable sequel.

To conclude: for the sake of argument accept Shiller's implicit assumption that to the present the marginal benefits of innovations permitted by capitalist societies have exceeded their costs. But until now the process of innovation has been restrained by the fears of potential investors and consumers who were reluctant to bear the risks of innovation without insurance. In Shiller's brave new world of greatly enhanced opportunity to share risks, the psychic brakes on proposed innovations hitherto imposed by traditional frames will be much less restraining, with losing projects more frequent or of greater magnitude than previously experienced. Shiller assumes that the gain from the increase in successful innovations will exceed the loss from more and greater failures. He may be right: but to make this case would require a full deployment of the undisputed technical prowess that he keeps under wraps in this stimulating volume.

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