

MEMORANDUM FOR THE RECORD

Event: Stephen Mihm, Professor of History, University of Georgia. Co-author with Nouriel Roubini of *Crisis Economics*.

Type of Event: Interview

Date of Event: July 29, 2010 (11-11:45 am)

Team Leader: Matthew Cooper

Location: FCIC, Phone Interview. FCIC participants used the large conference room. Mihm took the call from his car.

Participants – Non-Commission: Stephen Mihm

Participants – Commission: Matthew Cooper, Tom Stanton, Randall Dodd, and Adam Paul

MFR Prepared By: Adam Paul

Date of MFR: July 29, 2010

Resources mentioned:

Historical Statistics of the United States, Cambridge University Press

Thomas Philippon of NYU Stern School of Business upon executive compensation

Summary of the Interview:

The following is a summary of the conversation. It should not be taken as a transcript.

Cooper began the interview by explaining the FCIC's mission and introducing the participants. Cooper asked Mihm what he thought caused the crisis. Mihm said there were several issues on which there is broad consensus. "Regulators were not at peak capacity and Wall Street was operation in a way that was highly risky."

Then Mihm explained three causes that fit his historical background. He takes the view that "the roots of the crisis go back much further than the abolition of the Glass-Steagall Act" and as far back as the 1970s. There causes are:

1. Dramatic changes in compensation in financial sectors compensation
2. Increasing income inequality and rising consumer credit
3. The perception of government and regulators
4. End of the Cold War

I. Compensation and A-Students

First, Mihm outlined a dramatic change in compensation in the financial sector over the past 40 years. Mihm notes that the rise of compensation that begins in the 1970s mimics one seen in the 1920s¹. Deregulation was part of this story but rising compensation also went hand-in-hand with a change in the types of people being attracted to finance.

“People in the hard sciences, particularly mathematics and physics, who entered into a relatively job market in academia and eventually if not immediately went to Wall Street” or financial firms said Mihm. This increased reliance upon “quants” made the financial system more complex and opaque. No longer, said Mihm, were C students running the Street because the A-students had taken their place².

Stanton asked why greater intelligence threatened the economy. Mihm responded that smart people developed more complex products and the shadow banking system that made became unstable in the crisis. According to Mihm, “structured finance became complex for complexity’s sake, it was increasingly no longer a way of managing risk but a way of concealing risk.”

Mihm, who admitted that he has a bias against the best and brightest going into finance, said that these bright people designed a system of short term rewards. The use of leverage and outside financing lessened their personal risk while increasing their potential to gain bonuses. “When they failed they didn’t necessarily lose their jobs and certainly not money since it wasn’t there’s to begin with.”

II. Inequality

There were also problems on Main Street that allowed Wall Street to flourish. Most importantly was the stagnation of incomes beginning in the 1970s. As a result people turned to credit cards, college loans, etc. to finance spending. “There were seriously declining economic opportunities, particularly those people associated with the working class. I think that many of the things that filled the void temporarily were forms of easy credit.”

While Mihm did mention government policy, he warned that this trend was “not a conspiracy or a policy choice.” Still the need to access credit explains why people were so quick to embrace the new financial products coming from Wall Street.

Stanton followed on this point, asking what metrics the FCIC could use to evaluate this arch. Mihm pointed staff toward wage figures, including from the Census Bureau, and average home size. Dodd suggested that personal bankruptcy filing data could also be helpful, especially given recent changes in bankruptcy laws.

¹ See reference to work by Thomas Philippon above.

² Mihm referenced a piece by Calvin Trillin. “It’s sort of a joke but I don’t think it’s entirely a joke. The piece is “Wall Street Smarts,” By Calvin Trillin, *The New York Times*, October 13, 2009, http://www.nytimes.com/2009/10/14/opinion/14trillin.html?_r=1&em (accessed 7/29/10)

III. Perception of Regulators

Over the same time, the deregulatory push changed the national perception of government. The general public and regulators themselves developed a negative view of public service.

“If you said you were a regulator in the 1960s, people wouldn’t boo or hiss at you... It was not considered a dead-end job,” began Mihm. He explained that students from top universities increasingly went onto Wall Street rather than civil service. Mihm suggested that FCIC staff look for a series of studies released upon the post-college jobs of Harvard undergraduates.

“It doesn’t matter what regulations you have on the books; it matters what regulators you have to enforce them,” said Mihm.

IV. End of the Cold War

Mihm marked the end of the Cold War as an important turning point for businesses. Without the counterweight of Soviet communism, risk-taking was able to increase. “There were certain high-stakes in having the capitalist system remain operative and running well, since the fall of the communist system that disappeared and created enormous set of opportunities for countries to embrace laissez-faire economics.”

Not coincidentally, former Soviet states became sources of crises themselves. This includes Russia and the Ukraine. Mihm does not say that these were the cause of the crisis but that “1989 was serious turning point.”

Cooper asked if China can replace the bi-polar world. Mihm agreed but cautioned that the saving glut story “makes our spending seem like China’s fault.”

Cooper concluded the interview and Mihm agreed to send further information by e-mail if available.