

The Role of Incentives in the World Financial Crisis

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- **Causes**
 - Immediate
 - Underlying
- **Remedies - Good and Bad**
 - For Governments
 - For Firms
 - For Individual Investors
- **Prognosis**
 - General
 - Specific

Immediate Cause: **Subprime Lending**

- Easy borrowing created high demand for housing
- This demand was met by a lot of new construction
- Then defaults created a housing glut, so prices dropped
- Low down payments gave **incentives** to default
- This drove prices even further down
- The process continues ...

Underlying Causes:

- Overleveraging
- Entanglement (insurance – credit default swaps)
- Correlation (everyone doing the same kind of loans)
- **Incentives** for Bank Managers
- Negative Bubbles

Good Remedies:

- For Governments:
 - Regulate to avoid entanglement
- For Financial Institutions:
 - Avoid overleveraging
 - Use correct **incentives** for managers
- For Individual Investors:
 - Sit tight

Bad Remedies

- For Governments:
 - Abandon Market Economy
 - Bailouts
- For Firms:
 - Across-the-Board Lowering of Executive Pay
- For Individual Investors:
 - Panic Selling

Prognosis:

- World Economy basics look good

BUT

- Economic forecasting has never been very reliable

Gracias