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Interview with Gary Becker

by *John Cassidy*

I met Becker in his office at the economics department. I began by telling him I had been speaking with his friend and co-blogger Richard Posner, and I asked whether he agreed with Posner that the events of the past two years had called Chicago School economics into question.

Gary Becker: No. I think the last twelve months have shown that free markets sometimes don't do a very good job. There's no question, financial markets in the United States and elsewhere didn't do a good job over this period of time, but if I take the first proposition of Chicago economics—that free markets generally do a good job—I think that still holds.

If I were running an economy, and I was looking for the best way to run it, I would do what India and China did—move much more to a free-market economy. The second proposition of Chicago economics—that governments don't do a good job. I really don't understand how, if Posner said that had been undermined, he can infer that. I don't think the government did a good job in the run-up to the crisis. Posner has himself criticized Alan Greenspan's low-interest-rate policy. The S.E.C. should have done a lot of things it didn't do. It's hard to sustain the belief that governments do well.

What I have always learned to be the Chicago view, and taught to be the Chicago view, is that free markets do a good job. They are not perfect, but governments do a worse job. Again, in some cases we need government. It is not an anarchistic position. But in general governments do a worse job. I haven't seen any reason to change that other than, yes, we've seen another example where free markets didn't do a good job: they did a bad job. But to me there is no evidence the government did a good job either, leading up to or during the process.

Posner says that the government's interventions have staved off another Great Depression.

Well, that's a separate argument. Market economists—take my teacher and close friend Milton Friedman: [he was] a big advocate that the government should have done more during the Depression. The Fed should have done more. It was too passive and the money supply dropped, and so on. So it's been long recognized that there are situations when you need very strong, temporary government interventions. [Policymakers] did come in here, and they did help. It was a very mixed bag of different policies. I don't blame them too much for that. It was a novel situation and they were experimenting a lot. I definitely think they helped, though, overall in averting a much more serious recession. A lot of people, including Posner, thought that things were going to turn out a lot worse. We had a bunch of arguments about that on our blog.

Two of the big theories associated with Chicago are the efficient-markets hypothesis and the rational-expectations hypothesis, both of which, some say, have been called into question. How do you react to that?

Well, these are not areas that I have particularly specialized in, but let me give you my reaction. The people who argue that markets were always efficient and there was no problem, that was an extreme position—something a lot of people at Chicago had recognized before. The weaker notion that markets, particularly financial markets, usually work pretty well, and it's very hard to beat them by investing against them, that I think is still very powerful.

What I think we experienced, and where I think we went wrong, is that we'd developed a lot of new financial instruments, derivatives, and the like. Neither some of the people that developed them nor the practitioners really understood how these derivatives worked in different situations. Like mortgage-backed securities—I don't think you are going to see them being very popular in the future. So, there were innovations. They had good aspects, but they had aspects that didn't work out very well, and so the markets weren't very efficient in these cases.

Yeah, markets aren't fully efficient. Expectations go wrong. We've seen many other episodes in the past where expectations have gone wrong, where it looks like there were bubbles that happened. Certainly, in the housing market it did look like there was a bubble going on, and people were anticipating prices still going up. Nevertheless, the notion that people are forward looking and try to get things right, and often they do get things right—I still think that comes through O.K. You just have to be more qualified and more careful in how you state it.

That would be my interpretation. Yes, weakened in terms of simple mechanical application, but the general thrust that markets are more efficient than any alternative—that aspect I don't think is going to be changed. I don't think you are going to see the world moving away from markets, including financial markets…. I don't see China or Brazil, or a lot of other developing countries, making any radical changes in their movements towards the market, and I think for good reason.

If you take the last twenty or thirty years—take the good and the bad, including this big recession—growth rates are pretty good…. That's not only due to markets, but, certainly, market orientation and trade were the major factors responsible for that.

But what about speculative bubbles? I recall interviewing Milton Friedman, in 1998, I think, and he said he thought the stock market was in a bubble. The idea that Chicago economists don't believe in bubbles—was that more Greenspan?

Absolutely. I think bubbles have been recognized. Certainly, Friedman and others, including myself, said there are phenomena that are hard to explain without thinking it's a bubble. The people working in macro theory have had difficulty deriving these bubbles from any reasonably rational set of actors that are somewhat forward looking, although there are models that can do it now. That's an analytical challenge. But the fact that there have been episodes throughout history that were clearly bubbles, that foreign-exchange rates overshoot and undershoot their real values—yes, I don't think there's any question about that. I don't think that most Chicago School economists thought that these things didn't happen. I think most Chicago economists recognized that, and, certainly, Milton Friedman did.

Lots has changed at Chicago in recent years. What if anything is distinctive about Chicago economics these days?

It's not as distinctive as it was when I graduated with my Ph.D. from Chicago. In those days, there was a great belief in the price system, in people's incentives, and in linking theoretical research to empirical research. That wasn't common at most of our competitors. Both in micro and in macro, there were major differences. Chicago was hostile to Keynesian economics when I was in graduate school. Now there's been a lot of convergence, particularly in the micro side of things. Chicago is less unique than it used to be.

But I do think there is still a considerable distinctiveness about what might be called Chicago economics. One is skepticism about governments—that governments can organize activities well…. I think that is still a much stronger view in Chicago than in most other places.

Two, more from the micro economists who analyze markets and how people respond to incentives, I think Chicago economists still consider that more important than most other places and don't believe you can begin to understand how economies work, either empirically or theoretically, without giving that a major role. That's not as sharp a difference as it was, but I still think it is significant enough to say there is a difference between Chicago and other places.

Are these differences reflected in teaching?

It's certainly reflected in our course. [Becker and his colleague, Kevin Murphy, teach a graduate course in price theory.] Students tell us they haven't had a micro course like this before. It would be reflected in a number of courses taught in both the business school and the economics department, and also in the law school courses, including some of Posner's.

So the rest of the world has moved closer to Chicago?

No question. Quantitative work linked to theory and incentives—that's much more commonly found at our competitors. When I went out on the job market, there were some places that wouldn't hire a Chicago economist, like Berkeley, for example. For decades they didn't hire a graduate of Chicago. Harvard wasn't too thrilled with the idea either.

Do Chicago economists now get hired more widely?

Well, much more so than they did. Harvard has a number of Chicago people, liked Ed Glaeser and others. M.I.T. has several Chicago people. Princeton has several. Even Berkeley has one or two. I'm not sure. Stanford certainly does.

What about the notion of rationality and economics, which you yourself are closely associated with. How much of that is still valid?

I think most of it is still valid. It depends on what you mean by rationality. But if you take the view that consumers, on the whole, react to incentives in the way you would predict they would respond—you get very misled in the world if you don't put a lot of emphasis on that.

Now there's behavioral economics, which has two strands. One is extending the motives of people, which I worked a lot on from my dissertation on. Chicago was a pioneer in that. It's gone further, but Chicago was a pioneer.

The other aspect is that consumers make a lot of mistakes. I think there is no question that consumers make mistakes, and I think some of the behavioral-economics literature has made useful contributions in pointing out some of the types of mistakes…. That has been very useful but it certainly doesn't overthrow the notion … one, that consumers most of the time make pretty good choices for themselves; and two—now I come back to the government—they generally make better choices than a government body would make for them. That thing we started our discussion with, I think has to be brought into play in evaluating the implications of, say, behavioral economics or books like "Nudge."

A lot of behavioral economics has been devoted to finance. What about investors—are they rational?

Well, in the following sense. Not all investors are—surely not. But I think it's not very easy to do better than the market. If you look at the behavioral economists who run hedge funds, I don't think, on the whole, they have done much better than others.

It's not easy. Yes, there are a lot of mistakes made, but to take these mistakes and make money from them…. Some trends have been found—the small stock bias, and so on. It shows there are trends that can persist. But on the whole, if you look at financial markets they do a pretty good job—not a perfect job. And I think pointing that out has been a useful contribution. There was some theology built into the efficient-markets literature—some of it in Chicago. It became more theological than based on empirical evidence. So I think the attacks on it didn't

eliminate the real heart of it—these markets work pretty well—but there have been things that are puzzling to explain in a simple efficient-markets hypothesis.

What about the revival of Keynesianism, which, again, Posner is associated with? That goes directly against the Chicago School. What is your response to that?

Well, firstly, as a factual matter, there certainly has been a strong resurrection. That led me to believe that ninety per cent or so of economists were closet Keynesians all along, but they were afraid to admit it.

How much it has been resurrected? I have a bit of an open mind on that…. A lot of the more explicit Keynesian remedies, like stimulus spending and the like, will need an evaluation of what they did in stemming the tide…. I'm not yet convinced that fiscal policy was very effective in containing this recession. Take the fiscal stimulus package—eight hundred billion dollars. They've hardly spent any of it yet. The traditional argument against fiscal stimulus spending, even from those that believed in it, was that by the time Congress got around to deciding how to spend it the recession was pretty much over, so you were spending it at the wrong time. Some of that is going to be happening now…. I think history will say, once we understand it, that it wasn't very effective. The flexibility in financial response—it was understate in a lot of the previous literature, Keynesian and unKeynesian. That turned out to be important, I think. That's why I think the Fed, despite some mistakes, did a pretty good job.

What about the area of macro-economic theory. I know it's not your field…

It's not Posner's field either. (*Laughs*)

The models that Bob Lucas is associated with—rational expectations, dynamic general equilibrium models, and so on. Some people now say that they omitted so much—the entire financial sector was excluded—that they left the economics profession unprepared for this type of eventuality.

Well, I think [Lucas] made a major contribution. I think there is no doubt about it. On the other hand, I think some of the dynamic general equilibrium models that were being promoted in macro didn't turn out to be that helpful in helping us to understand what to do to combat a major recessionary event. If you look at the policies that were being advocated, both here and elsewhere, they were based on more traditional, I would say Friedmanite, type arguments. So I think there is some validity to that conclusion.

Obviously, other people took that approach even further than Lucas.

Yes, they did. And now we know that you've got to add more things into it. And I think we are going to improve macros, but I think some of the models were too simplistic. They captured important parts of the economy, but they weren't really preparing us for how to handle a crisis, I think that is pretty clear, particularly financial crises.

Surely, the models weren't merely designed not to handle crises. These models and their builders ruled crises out by assumption, did they not?

Well, some [did]. I don't think Bob would be one, because I think Bob always thought that money was important. Maybe some of his disciples, or others in the field, did, but I think you've got to make a distinction. I don't think everybody was on the same page on that. Some people did rule out the whole financial sector, seeing money as being unimportant. I think that stuff just turned out to be wrong.

The whole argument of money as a "veil"?

Right.

How do you think that the financial crisis will change economics? The nineteen-thirties revolutionized economics. Do you see that sort of change?

No, not of that magnitude. If this recession had got a lot worse, we would have seen two major changes: much more government intervention in the economy and a lot more concentration in economics in trying to understand what went wrong. Assuming I'm right and, fundamentally, the recession is over—a severe recession but maybe not much greater than the 1981 recession, or those in the nineteen-seventies—I think you are not going to see a huge increase in the role of government in the economy. I'm more and more confident of that. And economists will be struggling to understand how this crisis happened and what you can do to head another one off in the future, but it will be nothing like the revolution in the role of government and in thinking that dominated the economics profession for decades after the Great Depression. The Great Depression was a great depression by any measure you want to take—unemployment, decline in output, and so on. This recession pales in comparison. As a result, I think we are not going to have anything like the reaction we had at that point.

You already see it. There's been a backing away from some of the things that were being talked about. Pay controls—we are getting some, but less severe ones than people were talking about at the height of the recession.

Do you think that Wall Street needs re-regulating?

Well, I do. I think some additional regulation is needed, and I've called for some. But I don't think you can rely on regulators, because they fail along with the market. If we install rules for capital requirement that would work more or less automatically—I think there is a good case for that, particularly for larger institutions which we know we are going to bail out if they get into trouble.

Some people at Chicago don't accept the too-big-to-fail doctrine. They say, "Let them go."

There are two questions. What we should be doing and what we actually will be doing. I don't think we are going to let them go. We didn't let them go. We never let them go. Continental Illinois bank we bailed out at a time when it wasn't such a crisis situation. We bailed out Chrysler. So if you accept that we are going to bail them out you've got to do something to reduce the probability that we are going to have to bail them out.

Number two, should we bail them out? I think in this crisis we had to do it. I don't accept the view that in this crisis we should just have let everything fall where it may. Yeah—the economy would have picked itself up, but I think it would have been a much more severe recession.

So, you are in favor higher capital requirements on banks. Anything else?

Increase capital requirements. I would have a differential requirement for bigger institutions, so they can't get as big a multiple on their assets. Maybe derivatives markets—those are things I don't feel very expert on, but I follow the literature a little bit, and I think some changes are needed.

There are a number of things we should be thinking about. But one thing I should stress: I don't think the regulators did very well during this period, and we don't want policies that depend on a group of people living in Washington deciding on whether we should be doing something now or not. They didn't do it well this time. There is no reason to believe they are going to be any smarter the next time, because it's not going to be exactly the same situation that arises next time.

Do you favor a return to some sort of Glass-Steagall framework? Should we try to separate deposit taking from speculation?

I don't believe so. I think there are some advantages to combining them. But you may want to force derivatives to go through an organized market. Capital requirements. Swaps—you may want to have some controls on. I hesitate to say more. There are a lot of people out there who know a lot more than I do. But those are the directions I would go in.

A historical question. Chicago was always known for advocating deregulation of various industries—trucks, airlines, and so on. At the time, did people here talk much about deregulating the financial markets as well?

Absolutely. We got rid of Regulation Q—interest rate controls. Milton Friedman and most of us were big advocates of that. Glass-Steagall, there was a lot of opposition to. Derivatives—they came in during the nineteen -seventies, and they weren't fully understood…. But on the whole, in the nineteen-seventies, there is no doubt that there was support for deregulation of many aspects of the financial markets.

In retrospect, was that position right? Isn't finance different from other industries?

It depends. We've always had regulations on bank reserves and so on. So, clearly, yes, there are differences. You don't want to think in terms of free banking. I don't think people at Chicago ever thought… I'll speak for myself. I never thought, even outside the financial sector, that there should be no regulation. There are externalities. There's pollution. There are a lot of things you can do. In the education area, the government financing students, and all that. Those things go back a long time. So it was never zero regulation. It was just an observation that in many sectors regulation seemed to be throttling industry—like the airline industry, the trucking industry, all the stock-market regulations: prices were kept up. Nobody wants to go back to the time when you had a cartel and price-setting.

So people at Chicago did accept the need for dealing with externalities? What about Ronald Coase? [Coase, an English transplant who won the Nobel Prize in 1991, is famous for arguing that, under some circumstances, bargaining in the market will take care of externalities.]

Chicago didn't deny that there were externalities in the world. Chicago people were not anarchists. They always believed there was a significant role for government, and not simply in the obvious areas, like law and the military, and so on. In the educational area, take the vouchers system. It is government financed. There may be competition among providers, but it is government financed. Some help at the college level for people from poor backgrounds—there were many policy areas where Chicago economics tried to analyze what was wrong, and how you should go about fixing it, finding a better way to do it.

Was there anything, looking back, that Chicago got wrong?

(*Laughs*) There are a lot of things that people got wrong, that I got wrong, and Chicago got wrong. You take derivatives and not fully understanding how the aggregate risk of derivatives operated. Systemic risk. I don't think we understood that fully, either at Chicago or anywhere else…. Maybe some of the calls for deregulation of the financial sector went a little too far, and we should have required higher capital standards, but that was not just Chicago. Larry Summers, when he was at the Treasury, was opposed to that. It wasn't only a Chicago view. You can go on. Global warming. Maybe initially at Chicago there was skepticism towards that. But the evidence got stronger and people accepted it was an important issue.

But it hasn't changed my fundamental view, and I think [the view of] a lot of people around here, that, on the whole, governments don't manage things very well, and you have to be consistent about that. So I supported, say, the invasion of Iraq. In retrospect, I think that was a mistake, not only because things didn't go that well, but because I didn't really take into account enough that governments don't manage things very well. You really have to have strong reasons for going in.