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Timothy F. Geither, *Stress Test: Reflections on Financial Crises*, Broadway Books, 2015, 592 pp, $14 Paperback

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Abstract. This paper is a review about the book 'Stress Test: Reflections on Financial Crises' by Timothy Geithner. The book mainly discusses the policy decisions and implications of T. Geithner during his job as New York FED president and US-Treasury secretary under president Obama. The book reveals some hidden information about the decision-making process in both institutions. But it lacks a scientific foundation in order to explain the financial crisis in more detail. Hence, I think the book is less convincing than recognized in public. No doubt, Geithner crisis response deserves appreciation especially the 'Stress Test'. However, the overall book does not demonstrate that the response is sustainable in the long run and scientifically sound. Consequently, it is more a book on public policy and governance than economics.
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1. Introduction: Between Theory and Pragmatism

The new book published by Timothy F. Geithner in May 2014 with the title 'Stress Test: Reflections on Financial Crises', explains the working of the US-Federal Reserve and the US-administration. The book reveals interesting insights about public policy, governance, and the decision-making during the past financial crisis. Geithner was president of the New York Federal Reserve from 2003 to 2008 and thereafter secretary of the US Treasury until 2013. Thus, he was as close as possible at the centre of the American financial system during the first global crisis in the 21th century.

The book illustrates beyond all doubt important lessons to Americans and Europeans on almost 600 pages. However the present public book reviews, such as by the New York Times, Financial Times, or Washington Post are ambiguous and undecided about the books' influence. This book review, to my knowledge, is the first academic one. I discuss the policy implications of the book in general and the lessons for Europe in particular.

2. Discussion of the Book

2.1. Geithners' Life

The book is well written for the general public and not just for experts in the field. It lives from insider stories which are written in a sparkling manner. Apart

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from personal notes, especially in the first part of the book, Geithner talks about almost all policy decisions within his responsibility at the New York FED and the Treasury Department. The personal notes are probably more interesting for the general public but they contribute less to the reflections on the financial crisis. Apart from his political transition over years, from a left-wing Republican to a right-wing Democrat, the personal notes are distracting the reader from the title of the book. More interesting for the later discussion is the following: as a kid, Geithner had the chance to see the world while travelling with the parents. Moreover, his father had worked a long time in Asia. Accordingly Geithner gained an international perspective from an early age. In some way this is uncommon for a public figure in America. He frankly admits in the book, that he has problems with the common American view of dominance. This gives him some sympathy especially for non-Americans. Based on his internationality, a fact that other nationals, such as Europeans take for granted due to close cultures and countries, he learned foreign languages, too.

In his first job he worked as an analyst for a consulting firm of Henry Kissinger. Afterwards he worked in the US Treasury Department. Larry Summers, who was at that time Treasury undersecretary, helped him to get new jobs within Treasury. Finally, Geithner got the position as president at the New York Federal Reserve. So, the reader learns step-by-step about the authors' belief system and his personal values. From this point of time, Geithner turned into a public figure in the US. Consequently, in the following book review, I will study his economic decisions, his crisis strategy, and the implications for the US-economy and the World.

2.2. Geithners' View of the Crisis

A huge advantage for Geithner in all the jobs was his long-term experience and exposure to several economic crises of the past decades. Consequently, he gained broad and profound knowledge about financial crises over time. He has either studied or experienced financial crises for instance the Asian economic or the Russian currency crisis. Obviously this background shaped his character to develop a new style as a crises manager: less theory and more pragmatism. In the book, Geithner quotes a joking Mervyn King, the former governor of the Bank of England: "Tim was present at all the crises. But he didn't cause the crises. The crises caused him." This quote demonstrates that Geithner played a special role during the financial and economic crisis of 2007 to 2013.

Geithner believes that the financial crisis of 2007 has several vulnerabilities, such as the too low for too long interest rates, the global imbalances, the low mortgage standards or the flawed rating models. He is right in this assessment; however, he is wrong in believing that there was just one trigger mechanism. He states (p. 75ff): "It began with a mania — the widespread belief that devastating financial crises were a thing of the past, that future recessions would be mild, that gravity-defying home prices would never crash to earth." If this hypothesis is true he has to admit, that despite the lessons from earlier crises, all past and future policy interventions and regulations are worthless or ineffective. This ingenuous thinking is probably understandable but it is definitely not satisfactory from an academic or professional point of view. Blaming everyone and no one at the same time does not solve any problem. How can it be that nobody noticed what was happening inside the financial system until it collapsed? The reader got the attention that this rather innocent view has probably not contributed to make the financial system of today more resilient to future shocks.

As president of the New York Federal Reserve, he writes that he has asked questions about capital reserves such as "Do our banks really have enough?" Furthermore, he states that "I was more worried than many of my colleagues, but I was not nearly worried enough." For a reader surprisingly enough, if even he as an expert with a long-run experience was unable to see what was going on - who else can then see it? This is certainly not a promising insight. However, it reveals that a state administration can neither supervise nor monitor financial markets sufficiently. This is an important but old lesson from economic literature. This simple story demonstrates that regulation of markets require more than just laws and governance. In fact, it demands credible commitments as well as efficient incentives towards the values in a social market economy, such as for example in Germany.

2.3. Geithner the Crisis-Man

To solve a major financial crisis, he writes (p. 118ff and 211ff.), "you have to do things you would never do in normal times or even in a modest crisis. (…) What feels just and fair is often the opposite of what's required for a just and fair outcome. It's why policy makers generally tend to make crises worse, and why the politics of crisis management are always untenable." This statement illustrates the pragmatic solution Geithner is proposing in his book. To tackle a crisis from this point of view sounds logical at first, however it contains several questions and risks for the future.

Geithner was in charge at the New York Fed before and after the crisis. But why were he and his colleagues unable to avert the devastating turmoil? In terms of 'moral hazard' the majority of experts would argue – even he denies this in the book – that his pragmatic policy response has calmed the crisis in short-run but at the same time made the next crisis more likely and probably even worse. Frankly speaking, his crisis response was probably the best at that time, but it does not mean that it is the first-best long-run solution for the country and the World. We just have to wait until the next economic and financial crisis pops up. At the moment, there is a high likelihood that the next financial meltdown is even more severe than the past due to new moral hazard incentives and Geithners' bail-out policy in case of too-big-to-fail institutions. While reading the book, I got the impression that his crisis response was nothing else than kicking the can down the road. The moral hazard argument, which he considered as irrelevant and stupid, is not disproven in the whole book. In fact, the effect of the crisis resolution is still unclear and rather uncertain until today. Another recent book published by Thomas Piketty (2014) raises this subject too. However, Piketty believes that the big financial meltdown is still to come because of the rising inequalities.

In addition, the author reveals some naivety in another important issue. Geithner seems to believe that the behaviour and incentives within the financial industry, which drives bad standards of subprime mortgages, new structured products or low interest rates, were largely irrelevant. It is very unfortunate that he doesn't explain this in more detail. But according to Geithner a greedy investor is greedy due to the mania and not due to wrong incentives in the financial system. At this point in the book, I was missing an explanation with some academic background in particular behavioural economics or the insights from sociological system theory by Luhmann (1994).

Geithner's pragmatic policy follows a simple maxim: rescue the financial system no matter what it costs because a failure is even more expensive. However, why did investment bankers package bad loans into incomprehensively complex securities, such as collateralized debt obligation (CDOs)? Why did rating agencies declare these securities to risk-free AAA-assets? Interestingly, Geithner does not comment or explain this in the book. Probably, he realizes that the pragmatic point of view does not help here and now more theory and empirical evidence is needed for a better policy response (Gorton 2009, Hellwig 2009). Again, the informed reader feels that he neglects all the interesting and important topics. It is odd how little he seems to be interested in peoples' behaviour, although he considers the crisis primarily as a behavioural mania.

2.4. Geithners' Regulatory Response

Geithners' opinion about the new regulation, he has developed in office, is even more surprising in my view. He argues at the end of the book that the only serious weakness of the Dodd-Frank act is that it does not give the government enough power in the future. In other words, he believes that moral hazard does not exist at all. In addition, he cannot understand why ordinary people and experts still believe that the Dodd-Frank act has not tackled both the origins and triggers sufficiently. But at the same time, he never explains why roughly 5 percent capital ratio for big banks is enough. He does not mention academic research who argues for at least 20 per cent (Admati and Hellwig 2014). The reader got the impression that Geithner wants to be remembered as a Treasury secretary who has defeated the crisis with his team – and that is it.

Consequently, Geithner sees the guided response mainly as a success. He evaluates the American financial system more or less reformed today. Fortunately some facts in the book demonstrate that this naïve view is not conclusive. He himself realizes that the financial reforms are probably not enough: "Reform is a "forever war", (…). It is an endless process, and we left same unfinished business." (Geithner, 2014:505). Consequently, he admits that pragmatism was appropriate during the crisis but a scientific foundation is now needed to make the financial system resilient in the long-run.

3. Conclusion

Nevertheless, the crisis response he has developed for a global and systemic crisis in finance deserves appreciation. Frist of all, it was truly the first global financial crisis of this type in the 21th century. Even if his crisis response is neither generalizable nor new, it consists of four important parts. All this is summarized in the chapter Epilogue (Geithner 2014, p. 521ff.).

First the central banks have to act as lender of last resort according to Bagehot's law. This is not new and was already developed more than two centuries ago. Even Europeans, in particular the ECB followed this principle. Interestingly, Geithner even claims that he has influenced the famous London speech held by Mario Draghi in 2012. In this speech the ECB president said (Draghi 2012): "…the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough". This statement made clear that the ECB is also a 'Lender-of-last-resort'. Frankly, it has helped to calm the euro crisis but it has not solved the structural problems in Europe until today. But Geithner failed to say that Europe needs soon a political response and not just a monetary. Moreover, he should know better than ordinary people that the ECB does not have the same legal responsibility and mandate as the Federal Reserve.

Second the government needs to take the disastrous risk off the table by guaranteeing a broader range of financial liabilities. Moreover, this should be done boldly and swiftly in an epic crisis. Well, even this idea is not really new. It was already developed by Keynes in the 1930s. But he fails to notice that this enhance moral hazard and contribute to future financial crises. There is a lack of discussion about the flipside of this policy measure.

Third new financial regulation should insist on forcing capital into the financial system. A trivial demand, however in my opinion not appreciated enough by Geithner. He has not demonstrated why a 5 per cent capital ratio is sufficient in a globalized and too-big-to-fail financial system.

Fourth and finally, truly he invented a rigours stress test for the financial system that restores confidence as soon as possible. This element can be solely attributed to Geithner. It represents probably his greatest success during his legacy as a civil servant. Except the fact that he is the founding father of the so-called ‘Stress Test’ in a systemic crisis, the book is less remarkable than the title. Overall, this is more a book on public policy and governance than economics.

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