HOW MARKETS FAIL: THE LOGIC OF ECONOMIC CALAMITIES

John Cassidy, 2009, Farrar, Strauss and Giroux, New York, USA, pp. 390

Review*

How Markets Fail, by John Cassidy, is another in a run of books that feed off the corpse of neoliberalism. It is inspired by events pertaining to the current financial crisis. But this book is not just about finance, it also provides a rough overview of trends in the field of economics before concentrating on the theory of finance and on the current financial crisis. The book is divided into three parts – utopian economics or "bad" economics, reality-based or "good" economics and current crisis overview. One drawback of this book is this black and white division of economics, especially since a number of chapters are devoted to a specific economist. Thus, one might infer that this book also provides a list of "good" and "bad" economists. However, a thorough reading shows that the author praises the achievements of a number of "utopians", including Friedrich August von Hayek. This book is not a tombstone to free markets; it just wants to show that we do not need free markets all the time and in every situation.

In the first part, the author discusses the historical development and rise of utopian economics, a type of economics that works well in theory but somehow fails to perform once put into practice. Cassidy equates utopian economics with self-regulating markets or the free market economy. It is not that this is the only type of utopian economics, but this particular type is the main subject of analysis.

The origins of the free market economy are in the work of Adam Smith. Smith believed that the invisible hand of the market can transform individuals' selfish acts into socially desirable outcomes. All the state needed to do was to let the markets work its magic, and a few other things. It is well known that Smith did not believe that national defense, the enforcement of laws and public works should be left to the market. But what is less well known is that Smith also did not really trust financial markets and believed the state should actively try to minimize periods of financial hysteria and depression. Therefore, it seems the idea of self-regulating financial markets is of a newer date and cannot be traced back to good old Smith.

* *Received:* October 26, 2010
Accepted: October 30, 2010

One of the economists who took Adam Smith's idea of an invisible hand too far is Friedrich August von Hayek. Hayek was considered more of a political theorist of libertarianism than a fully fledged economist. His major contribution to economic theory is that people use market prices to convey information. Now, the information is fragmented (I may know something while others know something else) and the state might have the most information but it cannot have all the information. Therefore, Hayek concluded, the state cannot set prices. Setting wrong prices sends people wrong messages that distort their behavior. But, how do we know that the prices in a free market system send the "right" signals?

Hayek was more of a philosopher than a mathematician and providing the mathematical evidence that market gets prices right was started by Leon Walras and Vilfredo Pareto in the late 19th century. But the final touch was provided by Kenneth Arrow and Gerard Debreu much later. Arrow put forward two fundamental theorems of welfare economics. First, all competitive equilibriums are Pareto-efficient. Simply put, this was mathematical proof of the invisible hand. The second theorem deals with equity since some equilibriums involve higher inequalities than others. Arrow managed to prove that government, as long as it performs redistribution in an appropriate manner, can select the most socially desirable Pareto-efficient state and the market will generate the prices needed to support such a state. Interestingly, even though Arrow's theoretical work was a gospel of free market economics, when he offered policy advice it was mostly interventionist. After constructing his general equilibrium theory, in which prices reflect economic fundamentals in all markets, Arrow moved to explain why economies are not in a state of general equilibrium. The problem of general equilibrium theory is that it has some constraining and unrealistic assumption, like no economies of scale. An even bigger problem is when the economy is struck by an exogenous shock, e.g. September 11th or the creation of OPEC and a sudden rise in oil prices. A number of authors proved that in such a scenario, actors following conditions specified in general equilibrium theory can react in a bizarre way. Interestingly, one of these authors was Gerard Debreu himself.

The main populizer of the idea of free markets was Milton Freedman, who used a cunning way to connect his case with American tradition of individualism. Freedman claimed that economic freedoms were necessary to maintain political freedoms, thus connecting deregulation and privatization with fighting communism. Simply put, to further his cause, Freedman used language that the American people could understand and would accept.

The self-regulating market theory in finance is called efficient market theory, which claims that prices in the financial markets are tied to economic fundamentals (e.g., corporate profits). In other words, financial markets get prices right. This argument stems from the simple observation that movement of stock prices is difficult to predict. But, the jump from a well grounded claim that the prediction of future prices is difficult to claiming these prices must be right extremely dubious. In fact, there is some predictability in the movement of stock prices. More importantly, Gene Grossman and Joseph Stiglitz showed a logical inconsistency in efficient markets theory. Efficient market theory claims that every new piece of information will automatically translate itself into prices. Yet, if this were to be true, Grossman and Stiglitz argued, there would be no incentive for in-

vestors to look for new data since this data would be incorporated into prices before they could make a profit off it.

By 1980, the idea of self-regulating markets had become the majority opinion. In 1980 Robert Lucas, who would later win a Nobel Prize, for instance, claimed that no under-40 economist worthy of any respect could still be a Keynesian. In the 1970s, however, even right wing presidents such as Richard Nixon declared themselves Keynesians.

Part two is devoted to reality-based economics. This is not a unified school. Instead, its focus is on correcting numerous failings in the free-market economic theory. One of the major problems of self-regulating markets is spillovers. Implicit in spillovers is that there is discrepancy between social and private costs and benefits. For instance, using fossil fuels creates private costs, i.e. the price of fossil fuels, and social costs, global warming. The problem is that market actors are driven by private costs and benefits and neglect social cost-benefits because market prices do not incorporate them. Therefore, market prices can send some very wrong signals – it is, after all, rational industrialists that drive the global warming phenomenon.

Ronald Coase tried to resolve the problem of spillovers within self-regulating market theory. He pointed out that negative spillovers will be resolved if there are clear property rights in place and if the law is enforced. The idea is that a polluting company and individuals suffering from pollution will negotiate the best solution if the law clearly recognizes the one's right to produce and the other's right to breathe fresh air and live healthily. But Coase himself pointed out that his model will work only when negotiating costs are negligible. Unfortunately, in cases with large number of parties the negotiating process will be very costly, if it is even able to reach any conclusion.

The next problem with the free market economy is that it often leads to monopolies and oligopolies. For instance, W. B. Arthur argued that monopolies are endemic in the high-tech sector. His reasoning was that chance events and network effects can help an inferior to drive out a superior product. The logic behind his claim is that attractiveness of one product is not just its quality but how many people are using it. For instance, I will continue using Facebook or iPod even if there is a superior product on the market, provided that my friends use Facebook and iPod.

Furthermore, markets might behave weirdly in the presence of hidden information. As George Akerloff suggested in his analysis of the second hand car market, bad products can squeeze out good products. For instance, potential buyers might be very skeptical about the quality of the second hand cars. For one, if second hand cars worked well, why would their owners try to sell them? In effect, potential buyers might be very reluctant to pay a lot of money for used cars. In return, potential sellers of used cars might be reluctant to sell good cars, because they will not be able to get a good price. As a result, the second hand car market might be overflooded with "lemons" or bad second hand cars. In a nutshell, both hidden information and spillovers drive markets to send the wrong signals.

Markets can also send the wrong signals in the financial markets. For instance, market players prefer conformity. One research work showed that investors who used unorthodox strategies were more likely to get fired or miss a promotion. In effect, peer pressure makes investors adopt the strategies of the majority of investors, even if they are not too convinced

about its merits, because it is better to fail "conventionally" than "unconventionally". Furthermore, markets can lead investors to forget about fundamentals. In presence of noise traders, who concentrate on irrelevant information, it makes sense for sophisticated traders, who base their decisions on the fundamentals, to keep the prices rising because noise traders will just keep buying these shares, thus creating a bubble.

Research in psychology has put a serious question mark on investors' ability to concentrate on the long-term fundamentals. For instance, Daniel Kahneman and Amos Tversky showed that when outcomes are uncertain, people do not rationalize but instead use the rule of thumb. These mental shortcuts include a tendency to generalize on the basis of insufficient evidence (e.g., using small and unrepresentative samples), putting too much weight in one's own experience and a general inclination to judge things relative to arbitrary reference points. For instance, in the current debate on the success or failure of President Obama's economic recovery plan, pro-market economists argue that it failed because state intervention is always bound to fail, while the Keynesians argue that it failed because state intervention in the economy was not strong enough.

Still, probably the most devastating critic of efficient market theory was put forward by Hyman Minsky. Minsky argued that peoples' risk preferences depend on the overall state of the economy. Therefore, during good times, investors tend to be overly brave, taking more and more leverage and making even riskier investments. The end result is a bubble. But, when the bubble bursts, investors become overly cautious, avoiding even good investment options and thus leading the economy into depression. In a nutshell, free market economy's natural path is from euphoria to depression and then back to euphoria. Capitalism is, thus, inherently unstable, argues Minsky, and the government's job is to control the cycles of euphoria and depression.

Part three, consisting of seven chapters, is entirely devoted to explaining the causes and events leading to the current financial crisis. Charles Kindelberger argued that every bubble has five stages. It starts with some sort of displacement, in this case drastic reduction in interest rates, which creates a boom. Boom evolves into euphoria and after reaching a peak, the bubble goes bust. But, what made the current financial and property bubble different from previous ones was its geographic spread. While previous bubbles were geographically concentrated, this one was very widely disseminated. On the other hand, what it had in common with previous bubbles was policy-makers being blinded by an illusion of stability; financial innovations, which made speculation easier; and New Era thinking, characterized by overconfidence and disaster myopia.

Fed chairman Alan Greenspan kept interest rates too low for too long because of his belief in the new financial products' ability to diversify and minimize risk. But these new financial products also distorted incentives for the banks. For instance, securitization of bank debt allowed banks to transfer the risk of bad loans to investors who bought these securities. By doing this, the system created incentives for the banks to give out bad loans. Instead of rewarding prudence, markets began rewarding excessive risk.

Still, if the Fed did a lousy job in the events leading to the crisis, it did an even worse job after the crisis erupted. The main blunder that both Ben Bernanke, the new Fed chairman, and Henry Paulson, Treasury Secretary, shared was their belief that markets

would somehow correct themselves. Thus, after bailing out Bear Stearns, they let Lehman Brothers crumble in an attempt to send a message to the market that imprudent behavior will not be tolerated. Yet, this decision proved to be catastrophic because it caused panic on the financial markets. Luckily, their commitment to free markets lasted for less than 48 hours, when they bailed out AIG, America's largest insurer.

In conclusion, John Cassidy argues that current financial crisis was created by utopian economics and its belief that markets are always right. Quite on the contrary, we need to change our understanding of economics and accept that markets are a useful tool but with some important shortcomings, and this is precisely the job of reality-based economics. Unfortunately, it seems that little improvement has been made. The recent struggle to introduce universal and mandatory health care system in the United States showed that people still believe that there is only a choice between liberty (self-regulating markets) and socialism (state intervention). Furthermore, President Obama's plan does not go far enough in changing the system; it seems more a re-modification of the present system. And John Cassidy firmly believes that the main cause of this crisis was not "bad" bankers but a "bad" system, which distorted incentives and rewarded excessive risk taking over prudence.

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