the reading room

how markets fail: the logic of economic calamities

By John Cassidy
Allen Lane – Penguin Books
390 pages

review rating

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Apart form war, and perhaps constitutional certainty and the rule of law, there is nothing more important to mankind than economic management. Those who read the statistics of the Great Depression (see The Great Crash 1929, by J K Galbraith, this web site) or who see the horrifying photographs of the misery and hopelessness of the early thirties, will certainly attest to the gravity of economic management and the importance of avoiding anything approaching the misfortune of those times.

And yet, it is incredible to see, through John Cassidy's revealing exposition, what a dreadful mess we can still make of things, and how precarious was our lot during 07/09. He pulls no punches in allocating blame, and debunks economic theorist of various persuasions since Adam Smith – whether they have received Nobel prizes or not, and of course, many of them did.

John Cassidy was educated in economics at Oxford, but he does not cite his qualifications, and one needs to examine the Acknowledgements (tucked away at the back on p 371) to see how this story began in 1984 at his college entrance interview. From there he entered journalism, and has written for the SundayTimes, the New York Post, and since 1995 at The New Yorker. This book is a thorough analysis of economic theory and practice on a scholarly scale, and it traces the development of economic thought and the impact of this on public traded markets back to Smith. I would be surprised if any economist of note escapes attention. As well as the leading players (Hayek, Keynes, Marx, Friedman) there are numerous references to less appreciated figures in Europe, London and the US. His attention to detail is stunning, and he draws from his own records of commentary and interviews over sixteen years of study and writing. The source material is voluminous, but he has adopted a pleasant approach of eschewing foot notes (there are none) by adding a section of "notes" at the end, which link to chapters and pages, where the reader can see reference source detail. He has a readable style (doubtless due to his profession) which reminded me of Lord Denning, a great British judge with a penchant for direct and pithy prose.

Cassidy has structured this book into three parts: Utopian Economics; Reality-based Economics; and The Great Crunch, where, in October 2008, Greenspan admitted to Congressman Henry Waxman, that he was "partially" wrong during his term of office and the build up to the crisis.

In part one, we are introduced to the conventional wisdom and how this overpowered the clear warnings before the crunch arrived, eg, from The Economist in 2005 when it said that the worldwide rise in house prices was the biggest bubble in history. It was during this period that leading supporters of Greenspan openly declared their agreement with Greenspan's position on markets, and the developments within the financial industry generally – eg, Lawrence Summers, then president of Harvard and now an adviser to Obama. Chapter two sets the foundations for the free market hypothesis, starting in 1776 with The Wealth of Nations by Adam Smith, and the invisible hand concept, that still has application today, and which lies at the heart of laissez-faire thinking. This provided the foundation for Friedman and others of the Chicago School to build an edifice to Smith's memory, to the degree, that Cassidy is able to observe: "Utopian economics goes beyond a scientific doctrine: it is a political philosophy, a secular faith." But the road was not without bumps for the free marketeers, as in the early days when Hayek and Friedman were creating the Chicago School of economics, free market economists were relegated to the role of "preachers in an obscure sect… (and) when I (Cassidy) began studying economics at Oxford during the early eighties, Hayek was widely seen as a right wing nut. True, he had received the Nobel Memorial Prize in 1974, but this was viewed within the economics profession as a political sop". Sop or not, Hayek was to receive more acclaim when he received admiration from Margaret Thatcher – and then he was used by her for justification for her free market policies.

Part one then addresses: the general equilibrium theory; "spill-overs"; Parento-efficient analysis; Arrows impossibility theorem; the evangelical acclaim granted to Friedman (by Paul Krugman, Ben Bernanke and others, quite recently); the efficient market hypothesis of Eugene Fama (also of the Chicago School); and finally the triumph of utopian economics – where mathematical analysis became omnipotent. However, as Cassidy approaches the 1980s and 90s, doubters are swinging back to Keynes. Moreover, Main Street and banks are questioning the value of modern economic theory, and those who practice it.

In part two, Reality-based Economics, Cassidy agues his case for a more rational approach to the macro issues of this century. There is a useful commentary on climate change by reference to the Stern report, which is based on the research of Arthur Cecil Pigou: "Pigou's point is fundamental … the essence of utopian economics is that the free market, by generating a set of prices at which firms and consumers equate private costs and private benefits, produces an efficient outcome. But from the point of view of society, what is needed is a balancing of social costs and social benefits. Free markets don't lead to such a balancing." Cassidy explains how relevant this is today in dealing with global warming: "Global warming is just one of many damaging spillovers, and spillovers are just one of the many types of market failure."

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Arising from this weakness in free markets is Cassidy's adoption of the twin concepts of "the prisoners dilemma" and the related idea of "rational irrationality" – where a "situation in which the application of rational self-interest in the marketplace leads to an inferior and socially inferior outcome" and he uses this throughout the remainder of the book. A full chapter is allotted to the "Keynes beauty contest" and the many reservations Keynes had to free and efficient market activity. To Keynes, making financial decisions in a state of near ignorance was the normal course of affairs, and the "The most important (lesson) was that investing and many other economic activities are carried out on the basis of information that is limited and unreliable." Further, when it comes to the crunch, governments and banks, revert to Keynesianism, in that the most reliable cure for a deep recession is a big government "stimulus" package – p173. And so it was for 08 and 09.

Leading up to the 07/09 crunch, there is a useful outline of behavioural finance, "confirmation bias" and the return of psychology to economics. A chapter is allocated to Hyman Minsky and Ponzi Finance. Here Cassidy introduces more building blocks for the case justifying market intervention. Minsky died in 1996, but, one imagines, he would not be the slightest surprised with events of the past three years.. "Minsky advanced the view that free market capitalism is inherently unstable, and that the primary source of this instability is the irresponsible actions of bankers, traders and other financial types." Cassidy traces this through to 2007 and the observations of some that year, that the US was headed for a "Minsky moment, bordering on a Minsky meltdown."

By page 221 Cassidy is into part three, and his pace quickens – as does, it appears, his justifiable intolerance of the past collective errors of judgement, to say nothing of the disgraceful largess of corporate and banking executive remuneration. Some of the data and commentary is truly shocking:

• By 2006, US total indebtedness amounted to 350% of GDP – the US borrowing binge, borne out of record low interest rates, which increased total indebtedness from 2002 to 2006 by 42%, an increase of about $128,000 for every household in the country (Note: George Soros has pointed out that the US debt problem is now far greater than it was in the Greet Depression. "In 1929, total credit outstanding in the US was 160% of GDP, and it rose to 250% by 1932. In 2008 we started at 365% (ie, corroborating Cassidy) and this calculation leaves out the pervasive use of derivatives, absent in the 1930s" AFR Dec 29 to Jan 3 p54, *A global problem only the world can fix*

• The BIS had indirectly warned the US of the potential dangers of continuing down this debt path

• Between 1998 and 2006 Greenspan presided over two of the biggest speculative bubbles in American history

• Derivatives flourished in the 1990s, and the lessons from Orange County, Leeson/Barings and LTCM were never really learned

• The property bubble fed upon itself, in that the laws of supply and demand did not get repealed, but they did get suspended – and he convincingly explains how

• Bubbles erase prior history from the minds of the participants – with some helpful observations from Shiller

• Nowhere in the sub-prime securitisation chain did "anybody play the role of an old-fashioned bank loan officer, screening borrowers to ensure they could afford the loans they had applied for, and then monitoring their behaviour – rather, the market and regulators admitted egregious predatory lending

• Similarly, in the market for Collateralised Debt Obligations (CDOs) and Residential Mortgage-Backed Securities (RMBSs), credit analysis parted company with reality, as the rating system simply did not work, due to conflicts and other issues

• Securitising banks implemented off-balance sheet structures, by the use of SIVs (etc) to house securitised assets (CDOs and RMBSs), and they also took direct ownership of these, thus "They ate their own cooking and got poisoned"

• Banks also increased their leverage under credit default swaps, but there was no concomitant setting aside of capital to cover possible losses – exponentially increasing real (see through) leverage and lowering equity ratios

• The highly leveraged structures gave executives ample incentives to take excessive risks, which is precisely what they did.

Cassidy draws threads together in the final chapters dealing with the events of 2007 (in the US and in Europe/London) and he relates this to key economic theories as articulated earlier in the body of this book. There are very real linkages: to Keynes, to Minsky, to the Chicago School (somewhat dismissive), and to Shiller. He grinds through the loss of Lehman (a "stunning and inexplicable reversal of policy") and then gets into AIG and the activities of the Federal Reserve, and their realisation that political ownership of the disaster had to be passed to congress under the TARP program, with consequential and inevitable socialisation of loses through tax-payer liability.

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In his conclusion, Cassidy does propose specific measures to address clear shortcomings of regulation, and indeed this subject is still under review and current. He believes that it is "essential to put Wall Street in its place, and to confront utopian economics with reality-based economics" – and he has surely made a significant contribution to that end. As of January 2010, this is still partially work in progress. Given the size of the honey pot, and the veracious appetite of bankers and other market participants, one has to wonder whether we are really through the worst. Moreover, there is a real question as to whether this can all happen again one day not too distant from now – as the self interested forces to continue the mischief are considerable.

Capitalism is the better model, but Cassidy has shed light into several dark corners of this faith and he has challenged evident fallacies and hog wash.

Martin Earp
Noosa January 2010