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In search of imperfections

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Popular writing and films on the financial crisis have essentially followed two formats. The first (Andrew Sorkins's Too Big to Fail is an example) reads like a thriller where characters are fleshed out, a storyline evolves and different strands of the plot finally come together to produce a denouement, the financial crisis itself.

The award-winning documentary Inside job represents the second format that combines a "beginner's guide" analysis of financial markets and instruments with a simplistic harangue against contemporary economic theory. It accuses the latter of endorsing some of the decisions (excessive deregulation of financial markets, for instance) that were responsible for the crisis.

Neither, however, attempts a serious critique of the epistemology of contemporary economics. What exactly is within its paradigm that led to some of the faulty policies that ultimately precipitated the big bust of 2008? Roman Frydman and Michael Goldberg's Beyond Mechanical Markets — Asset Price Swings, Risk and the Role of the State tries to answer this difficult question and fills a key gap in the crisis literature.

But this book hardly falls in the genre of popular writing. Don't expect it to be a cracker of a read that you can pick up at the airport bookstore to stave off the boredom of a long flight. This is heavy material. Although it is not "technical" in that it does not contain equations or Greek letters, it assumes (at least implicitly) that the reader is reasonably familiar with modern economic theory, especially some of the more recent developments in macroeconomics. Uninitiated readers are welcome to give it a shot but I must warn that a fair amount of Googling is imperative to trawl the myriad references that pepper the book.

Frydman and Goldberg claim that the debate triggered by the financial crisis is unlikely to take us very far in understanding what went wrong, if it is confined to the existing conceptual framework that modern economics provides. The basic flaw in this framework is that it (as the authors put it) "attempts to account for risk and swings in asset prices with models that suppose that non-routine change is irrelevant, as if nothing genuinely new can ever happen". In this world, devoid of non-routine change, robotic individuals are assumed to take rational decisions and successfully predict change. There are "shocks" that rational market participants cannot predict that do occasionally surface but they tend to dissipate and markets return to equilibrium.

The other irritants in this near-perfect world are asset bubbles. These, according to the conventional paradigm, are created by the occasional desire of individuals to act irrationally and succumb to waves of market psychology. The way to prevent these bubbles is to try and make the markets even more rational by removing information distortions and deficiencies. The aim of policy, therefore, is to try and create this perfect little world in which the mix of rational behaviour and free markets delivers the best possible outcome.

The real world, however, doesn't quite function in this neat, predictable manner. Non-routine change is a constant feature of economies and societies. Market participants and policy officials are constantly thinking of new ways to use their resources and predict the future. Besides, the context in which individuals make decisions – the policy environment, institutions and politics – constantly shifts.

Asset bubbles and fundamentals, thus, are not one-off deviations from an otherwise "rational" course. They appear to be an integral part of the functioning of modern markets. Anyone who has been following house prices in Mumbai or Beijing should be able to tell you that. "Shocks" are not followed by a convenient return to equilibrium. Take the currency market. Exchange rates, as foreign currency traders know well, tend to deviate from their purchasing power parity path and this deviation could persist for years.

Thus, for any “theory” or framework to work and to guide policy, it has to take these kinks into account. Its assumptions need to reflect how individuals actually behave and act rather than build on the myth of a super-rational homo economicus. Behavioural theories of finance and economics have sought to formalise and incorporate some of these “irrationalities” but as Frydman and Goldberg point out, these have come out with equally mechanical and sterile rules.

The authors then propose a third way that they call Imperfect Knowledge Economics (IKE). Their approach jettisons some of the overarching mechanical rules for which the “rational” and “behavioural” schools us. Equally importantly, it allows for non-routine change and incomplete knowledge. While the first half of the book focuses on a critique of the current paradigm, the second explains the different dimensions of IKE and how it incorporates ideas such as the non-routine and the context-dependence of individual decisions without abandoning analytical rigour.

This is an interesting and important book in that it goes much beyond the box-standard “greed and fear” explanations of the crisis. While it has an academic style and is not easy to read, it is not written for academics alone. There is a lot in this book for traders, investors and regulators — for that matter anyone who wants to understand why markets work the way they do and how crises and catastrophes can be prevented.

BEYOND MECHANICAL MARKETS
Asset Price Swings, Risk and the Role of the State
Roman Frydman and Michael Goldberg
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