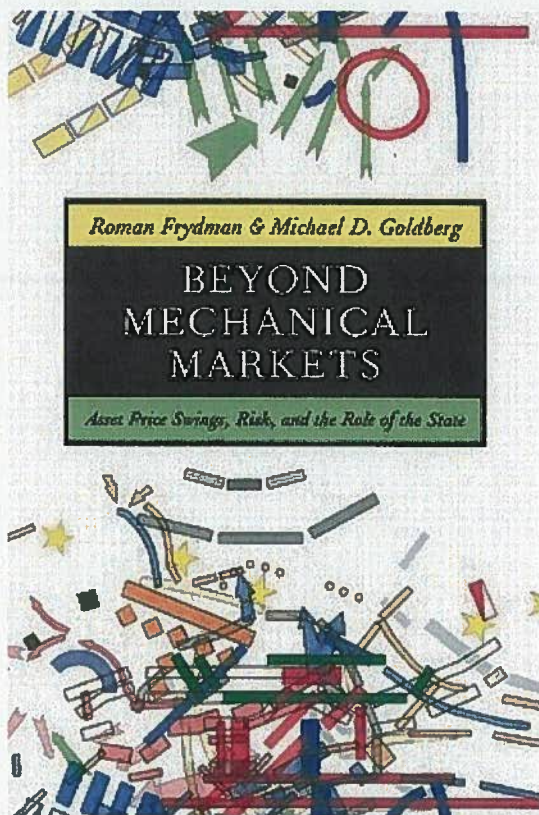


# Seeking Alpha $\alpha$

## Book Review: Frydman and Goldberg, 'Beyond Mechanical Markets'

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March 09, 2011



Participants in the financial markets as well as those who theorize

about them and set policy governing them yearn for predictability and, as much as possible, rigorous quantifiability. Alas, as we know only too well, their yearnings are for the most part intellectual fantasies. Roman Frydman and Michael D. Goldberg in "Beyond Mechanical Markets: Asset Price Swings, Risk, and the Role of the State" (Princeton University Press, 2011) offer an alternative approach to markets that they call Imperfect Knowledge Economics (IKE). I suspect that by now their friends and colleagues have deluged them with vintage "I Like Ike" buttons.

There are essentially three legs to the IKE stool. First, history does not proceed in a predictable way; change can be nonroutine. Second, market participants are neither predictably rational nor predictably irrational; they do the best they can with imperfect knowledge. And third, fundamentals are, well, fundamental.

Let's look at the question of fundamentals. The authors rely in part on a study that scores Bloomberg News daily market-wrap stories on the U.S. stock market (January 4, 1993 through December 31, 2009). These stories, the authors suggest, provide a "window into the decisionmaking of the professional players whose trading determines prices." (pp. 129-30) The scoring reflects the fundamental, psychological, and/or technical factors that were deemed important in driving prices each day. The result is that at least one fundamental factor was mentioned on virtually every day in the sample, at least one psychological factor was mentioned on 55% of the days (almost always in

conjunction with a fundamental factor— pure psychology was mentioned on only 1% of the days), and technical factors were mentioned on 6% of the days.

The authors admit that the data may be too soft to refute the bubble theory of markets according to which crowd psychology dominates and long upswings are unrelated to fundamental factors. Indeed, we know how tenuous the relationship often is between after-the-fact explanations of market movement and the real causes of that movement.

But they present other evidence, such as the relation between stock prices and current earnings, to press their case. They argue that even where swings are excessive "such excessive fluctuations result not because market participants' trading decisions ignore fundamental factors, but because, in forecasting future outcomes, participants must cope with ever-imperfect knowledge about how to interpret trends in fundamental factors." (p. 120)

Excessive swings in key asset markets, even if not driven by a herding instinct as is generally believed, are nevertheless obviously damaging to the economy. They "are associated with distorted relative prices and misallocation of financial capital" (p. 222) and can lead to financial crises. Therefore, excessive (and only excessive) swings should be dampened by regulators. The authors suggest some criteria for defining excess and some steps that policymakers could take.

Throughout the book as the authors take on proponents of the rational expectations hypothesis (who, they contend, are not all that different from the old socialist planners) and the efficient market hypothesis as well as the fabulists who view price swings as bubbles, they invoke the ghost of John Maynard Keynes. They offer a nuanced reinterpretation of some of his key ideas in support of their own.

And what is their central position? "Imperfect Knowledge Economics stakes out an intermediate position between erratic animal spirits and the contemporary presumption that change and its consequences can be adequately prespecified with mechanical rules. In contrast to the contemporary approach, the mathematical models of Imperfect Knowledge Economics explore the possibility that change and its consequences can be portrayed with qualitative and contingent conditions. These conditions are context-dependent, and ... the qualitative regularities that they formalize become manifest—or cease to be relevant—at moments that no one can fully predict." (pp. 253-54)

"Beyond Mechanical Markets" is a thoughtful book with an admittedly modest premise. I suspect that increasing numbers of macroeconomists and financial thinkers will start to build on some of their ideas as they struggle to make their models relevant to the real world.