SBP Research Bulletin
Volume 6, Number 2, 2010

BOOK REVIEW

How Markets Fail: The Logic of Economic Calamities

John Cassidy
Farrar Straus & Giroux, 2009, New York

The magnitude of the global credit crunch is such that it is compared to the Great Depression of 1929. Not surprisingly, a host of books have been written to explain the underlying causes and sequence of events that resulted in the spectacular collapse of Lehman Brothers in mid-September 2008 – this is generally acknowledged as the formal recognition of the credit crunch. Joseph Stiglitz, a Nobel-laureate economist, also published a widely read book (Freefall [2010]), where he referred to the credit crunch as the Great Recession.

Being an avid reader, and also a firm believer in market failures, I was drawn to Cassidy's treatment. The reason is simple: it put the crisis into the context of orthodox economic thinking – more simply, that markets are efficient and self-regulating. At a person level, what I particularly enjoyed was the trip down memory lane, where the genesis of laissez faire is flushed-out in a compelling and comprehensive manner.

I have always felt that good journalists have skills that economist do not have, and often do not cultivate: journalists question everything, and they are very engaging. *The New Yorker* is perhaps one of the most respected magazines in the world, and John Cassidy (who writes for it) is one of the reasons.

Before delving into my thoughts, let me broadly spell out the structure of the book. There are three parts to this book: (1) Utopian Economics; (2) Reality-Based Economics; and (3) The Great Crunch. The integrity of the writer is revealed by the fact that the credit crunch is kept for the end – in most books, the juicy bits are up front to engage the reader. John Cassidy does not compromise his narrative; he gives the reader a very rich context to better appreciate his final assessment.

Having said this, his 12-page *Introduction* is perhaps one of the most engaging I have come across for many years. He starts with the October 2008 hearings on Capitol Hill (Washington, DC) where Alan Greenspan (the ex-Chairman of the Fed) is asked to explain his role in the credit crunch – the old Maestro has fallen.

Cassidy’s opening sentence is: “The old man looked drawn and gray.” This wets the appetite, not just for details about what had happened, but more importantly, about Greenspan’s thought process as he allowed US capitalism to implode so spectacularly.

Utopian Economics brought back cherished memories of my schooling in theoretical economics. Granted, non-economists may find some of the chapters in Part 1 to be a distraction, but the purpose is to provide a rich context based on the work of giants like John Stuart Mill; David Recardo; Antoine Cournot; Alfred Marshall; Vilfredo Pareto; Frederich von Hayek; Gerard Debrue; Kenneth Arrow; and Joseph Schumpeter. What I found almost heart-warming, was the discussion of thinkers that many economists may not even be aware of: Leon Walras (pronounced Wal-Ra); Abba Lerner; and Oskar Lange.

So while Walras – the father of general equilibrium theory – formalized the perceived superiority of laissez faire economics, Lerner and Lange challenged this paradigm using equally mathematical techniques – their approaches differed on the basis of the pre-requisites for such efficient outcomes. Walras won, but the reasons why the others could not go beyond academic journals, gives the reader some insight into the “politics” behind the spread of purely intellectual pursuits.[1]

Adopting and promoting theories that suit one’s preference is understandable. But how did this theoretical structure survive unscathed in the tumultuous 20th century? The short answer is it didn’t – John Maynard Keynes happened. Keynes, who is perhaps the most famous economist the world has known, was more interested in public policy. Having said this, his professional standing was based on his undisputed credentials in top academic journals – he was also a strong proponent of government intervention.

The 1970s witnessed a challenge from Milton Friedman and the University of Chicago. Cassidy explains the intellectual birth of this challenge, but goes on to describe how practitioners (in Wall Street and the US government) started taking interest. Chicago School economists like George Stigler and Robert Lucas were soon deified.

---

[1] Did you know Adam Smith wrote *The Wealth of Nations* while employed as a private tutor to a wealthy aristocrat in Glasgow? Or that David Recardo was a self-made millionaire (speculator) who allegedly bought himself a place in the British Parliament? Or that John Stuart Mills was also a member of the British Parliament and a good friend of Recardo? This was the 18th and 19th century after all – the pinnacle of capitalism under the banner of *Rule Britannia*, and proud of Britain’s massively exploitative Overseas Empire.

This brings us to Part 2: *Reality-Based Economics*. The juxtaposition itself speaks volumes. After the free market enthusiasts gained ascendency, Cassidy describes the academic challenge to this paradigm based on two glaringly simple observations: information is imperfect (agents do not know everything); and economic decisions are not made in isolation (decisions makers look at other players and try to pre-empt their next move).

The reality of information asymmetries (the famous *Lemons* example) and the *Prisoner's Dilemma* is perhaps what non-economists are most familiar with. Brief refresher: Lemons refers to the dubious quality of used cars (do buyers know what they are buying?), while the Prisoner's Dilemma brings in psychology, information asymmetries, path dependency, and reactive decision making (do corporations decide on fixed investment, pricing, and marketing without considering what competitors are likely to do?).

Economics was under threat of being dragged back to becoming a social science.
Was there resistance? Yes, and primarily from the economic orthodoxy – those citadels of the top rated academic journals. Cassidy makes a very strong point with Akerlof. George Akerlof wrote a paper in 1967 called: The Market for Lemons: Quality Uncertainty and the Market Mechanism. Despite having a PhD in economics from MIT (undisputedly the best economics department in the world), and being a young professor at the University of California at Berkeley, his paper was rejected by all the leading academic journals. In the case of one journal, the referee said his paper could not be published because if his analysis were correct, "[the study of] economics would be very different."[2] This anonymous referee was spot on: Akerlof only managed to have his paper published three years later, but as Cassidy writes: "Four decades later, it [Akerlof's paper] has become one of the most widely referenced article in all of economics."[3] Akerlof went on to win the Nobel Prize in economics in 2001, and his other paper: Looting: The Economic Underworld of Bankruptcy for Profit [1993], Brookings Papers, was the inspiration for my own PhD dissertation at Stanford University in 1996.

Akerlof's (and I would add Stiglitz's) intellectual honesty could not sway the free market fundamentalists. For the *status quo*, information asymmetry was an inconvenience, which should remain in academia.

In the last two chapters of *Reality-Based Economics*, Cassidy talks about economic liberalization and the creation of asset bubbles – a clear prelude to Part

[2] *How Markets Fail*, page 153.
[3] Ibid, page 153.

3. Nevertheless, he anchors this discussion on the work of a little known economist called Hyman Minsky who published between the 1960s and 1980s; Minsky's research interests were capitalism, risk, asset bubbles and financial crisis. Although Minsky's work was published and debated, this couldn't stop the policy momentum in favor of financial deregulation – after all, Minsky thought "Wall Street needs taming."[4]

Part 3: *The Great Crunch* reintroduces the reader to Alan Greenspan, after the grilling he experienced in the *Introduction*. Cleverly couched under the chapter heading *Greenspan Shrugs,* Cassidy seeks to highlight Greenspan's lifelong devotion to Ayn Rand who died in 1982. Ms Rand was a philosopher /writer who is hailed by the American right-wing as a spiritual guide for Libertarianism; this school of thought does not believe there is any role for the government in society. Ayn Rand's most famous book was *Altas Shrugged* [1957].

Having explained Greenspan's ideological underpinning, the rest of the book recounts what happened before September 2008 under the spiritual guidance of Alan Greenspan – he clearly shrugged his way through the build-up to the Great Recession.

Part 3 contains chapter-specific discussions of the main ingredients that led to the credit crunch and developments afterwards: *The Lure of Real Estate* (who can resist capital gains); *The Subprime Chain* (how banks sliced and diced risks, and sold it to unsuspecting investors); *In the Alphabet Soup* (risk management techniques that were as complex as they were hollow[5]); *A Matter of Incentives* (bankers only did what made them money); *London Bridge is Falling Down* (how herd behavior can overwhelm any structure/system); and *Socialism in Our Time* (a cynical reference to the bailout of large banks and corporations at public expense).

Instead of explaining each of these ingredients, let me summarize Cassidy's assessment. The author does not mince his words when he talks about the Dot.Com crisis and the Great Recession: "When historians come to write about the "Greenspan Bubbles," they will do so with good cause: more than any other individual, the former Fed chairman was responsible for letting the hogs run

[4] Ibid, page 340.

[5] In the book, Cassidy talks at length about how banks used value-at-risk (VAR) models to justify excessive risk-taking. This was based on a selective use of data, and the fact that these quantitative techniques of risk management were effectively an alibi that bank management used to justify their portfolio choices to shareholders.

wild."[6] Although it is not considered good form to make *too* sharp an assessment, I feel such clarity is needed to drive a point home.[7]

In a nutshell, this is my assessment of what Cassidy says: Laissez faire economics made a strong comeback in the 1970s; policymakers and banks liked the story as it suited their interests; the superiority of a free-market paradigm became an article of faith (not to be challenged in public); regulation was considered inefficient (if not evil); and the accumulation of financial wealth was almost viewed (in a Calvinistic, pre-deterministic manner) as a sign of moral and spiritual superiority.

But it is the manner in which this happened that is disturbing. The choice in economic ideology is posed as being binary – "either you are for free markets or you are a rabid government interventionist."[8] Cassidy explains that what we have is a mixed system: "a hybrid of private and public enterprise, of decentralized activity and central supervision. Such a system isn't easy to reduce to intellectual slogans and sound bites."[9] But that is precisely what happened – sounds bites became an ideology.

Cassidy does not limit himself to historical analysis; he explains in some detail why President Obama's recovery plan has been compromised from the very beginning, as the same actors who presided over the collapse have been given the responsibility to fix the mess.[10] The author claims the Obama Administration is only tinkering while making radical statements of intent. He specifically mentions the failure to regulate the activities of big hedge funds and private equity firms, and the unwillingness to pre-certify derivatives. He mocks the reason that such regulation would stifle innovation, saying it is not just about state-of-the-art products but those that are robust and efficient – the Concorde is out of service, but the Jumbo Jet lives on.

---

[6] Ibid, page 336.

[7] In many ways, economic theory seeks to strip away clutter; to find clarity even at the expense of realism. Unfortunately, economists sometimes fixate on the shades of grey (the clutter), without realizing that in a social science there are no unambiguous answers.

[8] Ibid, page 338. This sounds annoyingly like President Bush's "you are with us, or you are with the terrorists" – and look where that has brought the world.

[9] Ibid, page 338.

[10] Although Greenspan's term ended in 2006, his successor, Ben Bernanke, continues to follow his policies; furthermore, the current US Treasury Secretary (Timothy Geithner) was the President of the Federal Reserve Bank of New York, before he took over at the US Treasury. With the status quo so firmly in place, it is tempting to say this is the root cause for the unconvincing US recovery – both Joseph Stiglitz and Paul Krugman, are also of this view.

On a final point, Cassidy targets the training of economists. He uses the words of Willem Buiter, who was with the Bank of England, and is now the Chief Economist of Citigroup: “Under the Influence of Robert Lucas and other mathematically inclined theorists, research “tended to be motivated by the internal logic, intellectual sunk capital and esthetic puzzles of established research programmes rather than by a powerful desire to understand how the economy works – let alone how the economy works during times of stress and financial instability.” Cassidy goes on to say: “Even today, all too many economists see their primary role as defending the market system against possible encroachments.”[11]

To summarize this review, John Cassidy traces the evolution of free market thinking, and highlights its resilience to innumerable crises in the past. One is tempted to say the beneficiaries have always been the most enthusiastic supporters of free markets, as revealed in the meek apologies emanating out of Wall Street after the Great Recession. The concern is that even after this event, economists and policymakers will find ways to resurrect this flawed ideology.

For non-economists, the book is a fascinating insight into the personalities that have defined this field; for free-market economists, it’s much needed soul searching; but for me, *How Markets Fail* is a celebration.

Mushtaq Ali Khan
Chief Economic Advisor
The State Bank of Pakistan
Mushtaq.Khan@sbp.org.pk

[11] Ibid, page 345. As an interesting aside, in his blog in April 2009, Buiter described Citigroup as “a conglomerate of worst practices from across the financial spectrum.” He joined Citigroup in November 2009.