The Benefits of the Bust

The financial crisis is leading to a new model of capitalism; the inadequacy of modern economics

By ANATOLE KALETSKY

An economist, a chemist and a physicist are marooned on a desert island. Their only food is a can of beans, but they have no can opener. What are they to do? The physicist says: "Let's try and focus the tropical sun onto the lid—it might melt a hole." "No," says the chemist. "We should first pour saltwater on the lid—maybe that will rust it." The economist interrupts: "You're wasting time with all these complicated ideas. Let's just assume a can opener."

This little joke, a favorite among economists, tells us more about the causes and consequences of the 2007-09 crisis than any number of ministerial speeches, Wall Street research reports and central bank monographs. The propensity of modern economic theory for unjustified and oversimplified assumptions allowed politicians, regulators and bankers to create for themselves the imaginary world of market fundamentalist ideology, in which financial stability is automatic, involuntary unemployment is impossible and efficient, omniscient markets can solve all economic problems, if only the government will stand aside.

In the new economy emerging from the financial crisis, the self-serving assumptions of efficient, self-stabilizing markets have been discredited, but something will have to be put in their place. Since the 18th century, each transformation of the capitalist system has coincided with a transformed understanding of economics—Smith and Ricardo from 1780 to 1820; the marginalist revolution of Mill, Jevons and Walras in the 1870s; Keynes in the 1930s; and Friedman in the 1970s. The new model of capitalism will also have to build on new economic concepts—and the events that followed the collapse of Lehman Brothers must surely provoke a revolution in economic thought.

The greatest embarrassment for academic economics in the 2007-2009 crisis was not the failure to predict the crisis but the failure to provide any useful guidance for politicians and central bankers after the crisis struck. The failure of analysis was much more damning than the failure of prediction because economics has never seriously claimed to be a predictive science. Keynes never published an economic forecast, and neither did Hayek, Ricardo, or Adam Smith. What economics did claim to offer was a set of analytical tools to explain reality and suggest sensible responses to unexpected events. It was in this respect that contemporary economics revealed its inadequacy.
Although the academic recommendations from the Left and the Right differed in almost every particular, including on stimulus spending, they had one striking feature in common—a detachment from reality that made them completely useless for all practical purposes.

One of the dirty little secrets of modern academic economics, for example, is that the computer models used by central banks and finance ministries to guide them in setting interest rates and regulating banks say almost nothing about finance. They simply assume that debts are repaid in full, that financial markets always function, and that money is “neutral,” having no effect on real economic activity, output and jobs. In practice, this jargon meant that politicians and central bankers who turned to academic economists for guidance in the financial crisis were effectively told: “You are on your own since the situation you have to deal with is impossible—our theories show it cannot exist.”

Financial booms and busts have baffled and fascinated economic thinkers since capitalism’s earliest days. It is therefore no surprise that the greatest financial crisis in living memory, after the bankruptcy of Lehman, elicited many different explanations. These ranged from excessive savings in China to policy mistakes by the Federal Reserve Board, from corrupt political lobbying to the immutable facts of human psychology, crystallized by the unforgettable two-word phrases from Alan Greenspan that punctuated the boom and bust: first “irrational exuberance,” then “infectious greed,” and finally “shocked disbelief.”

The issue at the heart of all the explanations of boom-bust cycles is the unpredictability of the future. This is what makes finance different—and more unstable—than other economic activities. The primary purpose of any financial system is to link decisions made today with events many years or even decades ahead. Savers, investors and businesses must resolve here and now how much to save or spend, whether to build new factories and which technologies to back, but all these decisions depend on views about the future—and those views, in most cases, can be based only on gut instincts, hopes and fears.

In nonfinancial businesses, market prices may move more or less rationally in response to measurable changes in supply and demand, but in financial markets, prices respond mainly to subjective expectations about events in a distant future that is often unknowable, even in a probabilistic sense. Modern economists sometimes pretend to overcome this problem by assuming that financiers make decisions by calculating future probabilities in the same way that normal businesses, operating in the present, count current profits and losses. But substituting probability distributions for observable facts does not solve the problem of uncertainty. It merely covers up the true problem, like a con man playing the three-card trick. Calculating probabilities may work well enough in the insurance business or in everyday banking, but in many events probability cannot be assessed. Recent events have offered spectacular examples.

What was the probability that two planes would hit the New York twin towers within an hour? What was the probability that the Soviet Union would dissolve without a shot being fired? What was the probability that the U.S. government would suddenly withdraw its backing for a systemically vital financial institution that everyone “knew” was “too important to fail”?

Business life consists largely of similarly incalculable, but more banal, questions about the future that simply cannot be answered, even in a probabilistic sense. What is the probability that someone in the next hundred years will invent a soft drink more popular than Coca-Cola? This probability must surely rate at almost 100%, yet that would also have been true in 1910. There is no rational way of making such an assessment. It is unclear if Thomas J. Watson, the chairman of IBM in the early 1950s, ever made his widely quoted remark that “there will be a world-wide market for maybe five computers.” But what is certain is that even as late as 1980, no one would have put any significant probability on computer sales exceeding car sales by a factor of 10 to one.
The role of inherent unpredictability in finance means that the most important prices set in financial markets—interest rates, exchange rates, stock market values and property values—will almost never correctly reflect conditions in the economy of today and may not create the right investment and saving incentives to keep the economy in equilibrium. Most of the time, the errors tend to cancel each other out or correct themselves quickly through normal market competition. But every so often, financial markets go haywire, succumbing to the alternating excesses of greed and fear that create boom-bust cycles.

Does this mean that financial cycles are pathological and immoral? The alternation of greed and fear certainly causes losses and economic disruptions in the short term, as well as suffering among innocent bystanders who have no involvement in finance, but in a longer historical perspective, financial cycles can be seen to play a crucial part in the evolution of the capitalist system.

Greed and fear, after all, are not unnatural or dysfunctional conditions. Natural selection has hard-wired these emotions into the human brain for good reasons. The great insight of Adam Smith was that greed, euphemistically described as self-interest, is the creative force that constantly drives humanity to improve the material world.

Greed is what gives impetus to the arrow of progress—and this is true not only of economics. In Chinese philosophy, the creative principle of yang is associated with aggression and acquisition. In politics, Machiavelli described the accumulation of worldly "glory" as the motivating principle that drives leaders to undertake "great enterprises" and do "great things" on behalf of their fellow citizens and not just themselves. But greed, whether for material possessions or for political glory, must be kept in check. Hence, the evolutionary value of fear. Fear, also known as prudence, caution or the Chinese yin, is just as important as ambition and greed for human success.

This is why the ring of repetitive financial cycles is needed as a countervailing mechanism to control the arrow of progress. In fact, the interplay between the arrow and the ring may be necessary for the capitalist system to evolve and improve itself, just as the balance between the greed for profits and the fear of bankruptcy is needed for businesses and industries to adapt and improve.

There are times, however, perhaps only once every generation, when the financial oscillations of greed and fear get out of control. At times like this, a political force from outside the market economy must intervene to moderate the financial cycle. Governments or regulators must have the power and the self-confidence to second-guess and override market signals. They must accept responsibility for managing economic activity and employment. And they must stand ready to support the financial system if regulation fails.

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