PART III

The Crisis of Economics

TEN

The Roots of the Crisis

:: SANJAY G. REDDY

> *Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.* —JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY*

The financial crisis itself has made it possible to have a new kind of conversation across the trenches of disciplines—the kind that is taking place in this volume. I do not think it would have been possible to have this sort of conversation five or ten years ago. There is a sense of shock that accompanies an unexpected event of this magnitude, and a searching for answers. This has rightly undermined previous disciplinary prerogatives and created a more welcoming atmosphere for new approaches.

Academics in various disciplines, as well as ordinary citizens, quite legitimately want to know what exactly happened, and how it is going to affect their futures. We have a new level of interest in economic questions and some skepticism about the previous answers provided. Economists in particular have been scrambling to provide answers, often in a rather *ex-post* manner. Precious few of them predicted anything like this particular event. Very few understood the current microstructure of the financial markets, which was so central to the unfolding of these particular events. As a result, there is a crisis of legitimacy of the field of economics just as there is a crisis of legitimacy of the banking system.

Even though this crisis has created an opening to address all sorts of important questions, nevertheless we are at a very early stage of the dialogue. There is a great deal of mutual education that has to take place in order to make it fruitful. I would like in this essay to touch on a few themes that I think are fruitful for such a transdisciplinary dialogue. How can we take advantage of this moment to reflect *together* about the political and institutional arrangements that undergird the contemporary economy? Can we not only understand better how this system has worked (or not, as the case may be) but also how it might be revised so as better to promote the ends of justice?

It is helpful to begin by taking seriously the title of this volume as a whole, *The Intellectual Origins of the Global Financial Crisis*. What are the intellectual origins of the present global financial crisis? In intellectual history it's quite common to think about the relationship between previous ideas and current ideas, as well as to explore the relationship between ideas and events, or occurrences in the world. How is the relation between ideas and facts in the world manifested? Of course, the individual actors who possess those ideas are consequential. Who were the actors in this case, and what are the ideas they possessed that led to the relevant transmission? Economists were very much at the center of this process of the provision of the intellectual rationale for the complex financial derivatives that were developed (which were the basis of the various kinds of toxic assets at the heart of the crisis) even if they played a subsidiary role in the development of the markets in which such assets were actually traded.

Toxic assets that have been at the center of this crisis were developed by "practical men, who believe themselves to be quite exempt from any intellectual influence" (to use Keynes's phrase from his seminal *General Theory of Employment, Interest, and Money*); they have also been very much supported by (not so defunct) economists. Very often the work of financial economists such as Fischer Black and Myron Scholes in the 1970s—on the pricing of options and other derivatives—is pointed to as the origin of these developments, but there is a deeper origin still. Kenneth Arrow and Gerard Debreu put at the very center of modern economic theory the idea of complete contingent claims markets. Their implied conception of a market utopia was a world in which it would be possible to write contracts involving all possible states of the world, which would specify what each of us would owe one another if one of many possible contingencies would arise. Derivatives contracts are precisely such securities. Arrow and Debreu argued that in a world of complete contingent claims markets, efficient (or Pareto optimal) outcomes would under certain conditions arise. The heaven of economists and, of course, their conclusion rested on certain premises about the rationality of the agents and their ability to foresee the future. However, these assumptions were treated as not wholly implausible. So if one wanted to lay the blame, one could do so in part on the shoulders of Arrow and Debreu.

I remember personally in graduate school talking to a then PhD student at the Harvard Business School, who is now a tenured professor at one of the foremost business schools in the United States, who was previously a banker working on a derivatives desk of a leading investment bank in New York. I had been reading some of the semipopular work of people such as Randall Dodd, one of the unsung heroes of this debate, who from the early 1990s had been pointing out the possible dangers of derivatives for systemic stability. It says much about the times that such persons were accused of understanding very little economics by the mainstream economists who saw no danger in the explosion of the derivatives markets, if they had noticed it at all. Indeed, my friend informed me that I understood very little about economics, obviously, and I must have had no idea what derivatives were if I thought that they could generate systemic instability. I was told that it was immediately obvious, from their very definition, that a derivative was a risk-reducing instrument and could not be a risk-increasing one. I'm sorry to say that this point of view was not uniquely held, and it was in fact the dogma of the time among academic economists generally and among financial economists in particular with some very rare exceptions. Even distinguished financial economists such as Robert Shiller, who is associated with the view that there can be "irrational exuberance" in financial markets, recognized that manias, crashes, and panics are endemic to all financial markets, but did not give importance to the role of derivatives in generating systemic instability. On the contrary, Schiller argued that derivatives can play an important role in providing insurance against sources of risk and instability.[1]

The recent historical experience provides an important case of economic ideas influencing the world. Other ideas also lie behind the phenomena we have observed—for instance, political ideas concerning the degree of deference that should be given to technocrats. There is a need to better understand what degree of deference should be given to proclaimed technocratic expertise in the organization of the economic system. This is a discussion that has unfortunately been avoided in the last three decades, at considerable social cost. Discussions in this volume have rightly focused on this issue, as well as the more general question of the appropriate relation between "capitalism" and the institutions of democracy, including the regulatory state. Let me therefore now focus on the question of whether "capitalism" is the root of the financial crisis, which has been posed by the organizers of this valuable volume based on an equally valuable conference.

I think the most fruitful way to approach this might be to note that "manias, crashes, and panics," to use the memorable phrase of Charles Kindleberger, are endemic in market systems. One can find historical examples of such mania, crashes, and panics going back a very long time indeed. There are very deep reasons why these manias and bubbles are endemic to market systems. At root, the source of these bubbles is the fact that financial assets have indeterminate valuations that are influenced by expectations of the future. Since valuations are at least partly based on future expectations, they are influenced by the psychology of market participants. Therein lies the problem for the "science" of economics.

Negative feedback mechanisms dampen down deviations from "equilibrium," or fundamental prices, which are experienced in financial markets at least over the short or intermediate term. For instance, higher prices for financial assets relative to the stream of returns perceived to be attached to them may lead to decreasing demand for them and thus mitigate price increases. There are also positive feedback mechanisms in financial markets, which exacerbate deviations from "equilibrium," or fundamental prices. For instance, higher prices for financial assets may lead to greater perceived wealth, which in turn leads to higher demand for such assets. Such positive feedback mechanisms can generate what are called bubbles, which involve bloating of asset prices, at least for a period.

In mainstream economics bubbles are usually wished away. Those who have studied economic theory at an advanced level will be familiar with a mathematical concept known as the transversality condition. It is usually imposed in macroeconomic models of the standard type and has the effect of simply wishing away the occurrence of bubbles. We know that a central economic reason why bubbles emerge is that it is entirely rational to hold a financial asset that one does not believe has a sound valuation (in relation to "fundamentals") if one believes that one can with considerable likelihood pass it on to someone else at a higher price. As long as there are "suckers," there is the possibility of bubbles, and indeed of rational bubbles. The transversality condition asserts that one cannot do that forever; there is some point at which one cannot find a "sucker." As long as that point is "not yet," then it's perfectly rational to participate in the bubble, although of course one does not want oneself to be left "holding the bag." It is clear that there can thus be systematic overshooting of the "fundamental" or warranted price of assets in financial markets, although it is also difficult to establish what such a price is.

What separates the recent financial crisis from the "garden variety" of manias, crashes, and panics? In referring to garden-variety manias, crashes, and panics, I am not taking the view that such crises are not important, or that they cannot have tremendously disruptive effects. Take for example the Japanese real estate bubble of the late 1980s, which when it collapsed, seemed to propel Japan into a deep depression from which it has not yet emerged. Although that was a bubble with enormous macroeconomic consequences, I would say that it was a garden-variety bubble in the sense that the value of the underlying asset, for instance a square foot of central Tokyo real estate, was known by the primary market participants, just as hundreds of years earlier the price of tulip bulbs was known by all of the participants in the infamous historical bubble of the Dutch Golden age. At any one moment in time (from month to month or week to week even if not from minute to minute), the market participants knew the market price at which the key asset traded. At a certain point in time the asset was trading at a very high market price, and then at another point in time, perhaps the very next moment, the bubble had burst and it was trading at a very low market price. However, the price was transparent to all of the participants (and, even more basically, the object was well defined). The garden-variety bubble centers on a financial asset that becomes overvalued, but the price of which is known at any one moment in time, before or after the bubble bursts.

One crucial difference between the garden-variety crises and the present crisis has been that the present crisis has, to a greater degree than previously, involved an epistemic problem. The market prices and warranted values (e.g., the stream of returns that might be expected by holding them to maturity) of the financial assets, which were traded (or, more pointedly, not traded) during the unfolding of the recent crisis—were to an extraordinary extent opaque to the market participants themselves. The radical uncertainty concerning the appropriate values to ascribe and the market valuations that would emerge if these assets were actually observed to be traded led to considerable confusion on the part of the market participants.

It is really remarkable that major financial institutions with enormous sophistication and resources with which to hire the best available experts were not able to determine what their net assets and liabilities are, despite the considerable work on accounting conventions for derivatives that preceded the crisis. The crisis has made bare that accounting involves conventions, that those conventions are based on underlying theories as to how the world works, and that those theories can be upended, in which case, rampant confusion can be sown among all concerned. There can be as a result such deep uncertainty about the values to be attached to the assets being held that trade in those assets might for a time stop! The story of how markets temporarily "froze" has many elements to it and may have yet to be fully written, although there have been recent highly illuminating contributions.[2]

The recent financial crisis has shown us that markets can go missing temporarily as a result of radical uncertainties (in turn tied to the informational complexity involved in valuing the underlying assets) and that such problems in valuation can lead to various knock-on effects, for instance by decreasing confidence in the liquidity and solvency of the major actors in the financial markets and causing a resulting decrease in economy-wide credit. This is a quantitatively different feature of the current crisis, although it has features of traditional manias, crashes, and panics. From this standpoint, advanced *financial* capitalism, which has emerged over the past forty years of financial innovation, is one of the most important roots of this crisis. The primary lesson of the crisis is that we must establish a new role for the public interest in the governance of the economic system. The public interest has in the years preceding the crisis been insufficiently respected, even if often invoked. It is appropriate here to recall the insistence of Hannah Arendt that the 'public' is not grounded merely in overlapping interests but rather in the recognition that we live together in the world, sharing it 'in common', from which recognition our sense of public responsibility must stem.[3]