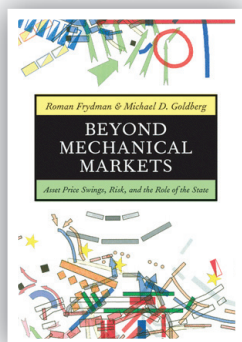


# Theory fanatics



**TITLE**  
Beyond Mechanical Markets

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**W**hat shortcoming do so many modern-day economists share with the architects of the old Soviet central planning system? “Fatal conceit,” argue Roman Frydman and Michael D. Goldberg, academic economists themselves, who echo the post-crisis criticisms of their profession with something approaching relish.

This book harks back to the old masters – Keynes, Knight, Hayek and others – all of whom emphasised the importance of non-routine change and imperfect knowledge in analysing market outcomes. But contemporary theorists, it claims, have absurdly assumed these considerations away. Pursuing omniscience in their fantasy worlds, they have ignored Keynes’s warning that it is “better to be roughly right than precisely wrong”.

This is not a knee-jerk reaction to the turmoil of the past few years: the authors had expressed such reservations well before the financial crisis. So their criticisms, though not original, are thoughtful and piercing – with a whiff of “we told you so” to keep things fresh.

In the “Orwellian world of rational expectations” individuals are robots and markets are mechanised. Change is predictable. Predetermined mathematical models can forecast the exact probabilities of all possible market outcomes. This is fanciful nonsense, it is argued; mere pseudoscience inept at explaining real-world observations, and dangerous when adopted by policy-makers (as seen in recent years).

More recently fashionable behavioural theories of the market are condemned for much the same reason. Behaviourists correctly identified that the established tenets of rationality do not adequately

explain individual behaviour – only to conclude that individuals must be irrational, rather than these tenets baseless. Most, but not all, cling to the fundamentally flawed belief in a market determined by overarching mechanical rules.

Put simply, prevailing economic thinking strives to know what is unknowable at the expense of what is useful. And yet despite emerging from the financial crisis red-faced, practitioners of this baffling mathematical alchemy still have a monopoly over policy-makers.

A real alternative, say Frydman and Goldberg, is their own invention: Imperfect Knowledge Economics (IKE). IKE takes a narrative approach to explaining markets, placing non-routine change at its very centre. Its mathematical models make qualitative predictions based on context-dependent conditions, which can cease to hold at unpredictable times.

Is there anything to this? Two Nobel laureates in economics and a handful of notable commentators have offered gushing endorsements. The later chapters of this book describe how IKE can explain asset price swings more convincingly than extant theories, and offer some impressive insights into empirical findings hitherto considered anomalous.

There are practical implications for the role of the state in curbing market excesses. Governments should be cautious but ever ready to intervene; never to force the market, but neither to shirk from guiding it when necessary. Policy-makers must act with discretion, treating each case on its own merits. For instance, a potential asset price bubble tempered too early will inhibit productive economic activity, but to wait too long can result in gross misallocations of capital. And there are solid proposals too, such as compelling rating agencies to publish at least two scores – complete with methodologies – for each security they rate.

Frydman and Goldberg break down more than they attempt to build back up, and their criticisms of pre-determined theories of the market have been made before. But they do not deny this. As they see it, IKE builds upon Karl Popper’s observation that the future is “objectively open”, in a way that conventional economics cannot. This book is not going to confine rational or behavioural market explanations to the graveyard. But its criticisms are potent and its suggestions intriguing. It would be a pity if they were ignored by economists too busy working on their next theory of everything.

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