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Better models alone won't avert crises

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By James Mackintosh
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Behind the politics of the past century were two extremes. At one end was what has become known as "freshwater" economics, after the University of Chicago intellectuals who championed it: **markets are always right**, so the less fettered free markets are by government, the better. At the opposite end was the claim that markets are no better than gambling, so state intervention is required to direct resources to where they can best be used.

From the collapse of the Soviet Union onwards, proponents of free markets were in the ascendent. Now they are in full-scale retreat. Unlike the 1950s, there is no appetite for Soviet-style state control, but the use of free markets is once again being likened to "casino capitalism".

Policymakers are scrambling to rework rules based on assumptions that **markets know best**. Banking regulators, in particular, implicitly assumed markets were efficient, relying merely on past price volatility (using value-at-risk models) to determine the riskiness of trading portfolios. They also assumed recent history was a good guide, allowing banks to use data that in many cases only went back 20 years to determine default risks on mortgages.

It should be no surprise that the combination of absolute certainty about the models and poor information about the models' inputs led to bad predictions.

Among the attempts now being made to find a middle ground is one that takes a different approach to the models. Roman Frydman and Michael Goldberg, respectively academics at New York and New Hampshire universities, reverse the thinking: they suggest there should be uncertainty about the models and more transparency about inputs. This leads to what their new book calls "**imperfect knowledge economics**"*, and to models with outputs investors should be aware might be wrong.

But why develop a new model? At least part of the reason for the 2007-8 **financial crisis** was the excessive reliance on models, which led to daft investment and lending decisions, most visibly in subprime mortgage securities. The intellectual triumph of the freshwater economists also led central banks to think they should not intervene even when markets got out of hand.

As they reverse these policies, regulators and politicians are reverting to a common-sense approach. The experience of communism has shown that markets are better than politicians at allocating capital, and the heavy hand of the state is, mostly, being resisted. Equally, markets are not perfect, and need to be guided away from excess from time to time.

This is already visible in Britain's new approach, which will see the Bank of England's financial stability committee take powers to intervene – for example, setting loan-to-value limits or raising bank capital requirements if lending gets out of hand. It is also visible in the swing by the International Monetary Fund away from its automatic criticism of managed exchange rates.

All this is anathema to free marketeers. Ben Bernanke, chairman of the US Federal Reserve, famously pointed out in 2002 that to prick market bubbles, central bankers would have to think they were smarter than the collective wisdom of the market – an unrealistic assumption.

Common sense says that at extremes, it is not that hard to see a bubble; but investors feel they must buy even at silly prices because they expect to be able to pocket a quick profit by selling when prices get more barking.

It is this short-term thinking – a variant of the well-known momentum effect – that makes it plausible that regulators could spot moves to extremes in markets and intervene to help dampen price swings.

Is common sense enough, though? Mr Frydman thinks not. The economics profession is not about to drop its efforts to produce models, and they will continue to be based on flawed assumptions about markets – and to win over politicians and regulators. The only way to win the public debate is to come up with an alternative that sets out better how the world works.

Imperfect knowledge fits with common sense, but the theory goes further: the authorities should not just intervene when valuations are extreme, they should set out in advance guidance ranges.

This is much harder. Financial bubbles are like pornography: as US Supreme Court Justice Potter Stewart famously said, “I know it when I see it”. Setting even a very wide range for valuations will still mean it has to change occasionally, as fundamentals sometimes justify moves outside the historic range.

That will leave regulators vulnerable to “this time it’s different” arguments as prices hit extremes, just as they are with reliance on common sense. The willingness of politicians, even now, to help support obviously overvalued asset prices, such as London housing, suggests a better financial model will not prevent future crises on its own.

* Beyond Mechanical Markets, Princeton University Press

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