

**Cassidy, John – How Markets Fail: The Logic of Economic Calamities***Picador, 2009, [Economics] Grade ★★★★★*

This is one of the books I have enjoyed the most during the last few years. And I believe it is an important book, too. It is an intellectual journey of the history of economic theory. One can't avoid being amazed by all the tricks economists have played in order to try to transform economics into being a natural science with almost mathematical perfection.

The purpose of the book is to explain why and how markets fail. Probably being too much of a libertarian myself, it is still easy to agree with most of New Yorker journalist John Cassidy's conclusions. The modern theory of the invisible hand, promoted by Friedman and others, that "self-interest plus competition equals nirvana" is simply not valid. Rather, this doesn't represent all the factors in the equation. Nobel Prize winner Lucas theory of the rational man is for sure not rational if one takes into account all the data processing that needs to be done accurately in the rational man's mind. We have learned a lot from behavioural economists like Kahnemann, Tversky and others, and we have a lot more to learn. "As happened in the 1930s, the unfettered free market has disgraced itself in full public view. Our system failed in basic fundamental ways", Timothy Geithner said in March 2009. "To address this will require comprehensive reform. Not modest repairs at the margin, but new rules of the game". Not enough has happened yet. Without a doubt, we will see more markets fail going forward. Economic theory needs to be more reality-based.

They say the beauty is in the details. And the details to look for are the assumptions behind the economic theories and their probable implications. That is one of the lessons in the book. I am surprised that so much time is spent on discussing the projected outcome of an action, and so little on the assumptions behind the model of thought. But I guess that goes for equity research as well...I like the set-up of the book, despite the author's worry of being too cursory, with its three distinct parts: Utopian Economics, Reality-based Economics and The Great Crunch. The "battle" between the utopian economics and the reality-based one is the main strength of the book.

The portraits of the economists and their life's work are one of the highlights of the book. It's a true pleasure to read these mini-stories. And it's done in a balanced and respectful way - with no backstabbing - that really helps you understand the progress of economic thinking. Some of the most interesting characters are: Adam Smith, "Prices gravitate towards a natural price", where suppliers don't make any unexceptional profits; Hayek, "We must look at the price system as a mechanism for communicating information"; Walrus, "In economics, everything depends on everything else"; and Pareto with his optimality, even though, according to Amartya Sen, "In short, a society or an economy can be Pareto optimal and still be perfectly disgusting."

Especially intriguing is the part with Arrow & Debrau and their explanation for the existence of equilibrium for a competitive economy. The problem is there is no assurance that the equilibrium is unique - there might be dozens of solutions. And the equilibriums might not necessarily be stable over time either. Friedman, the evangelist on monetarism and a stubborn critic on government intervention, and Fama, the proponent for the theory of the efficient market, became global brand names, while few learned of the market pricing wisdom of Mandelbrot. The most important driving force of them all might have been Lucas - who with some collaborators "developed a new way of thinking about economic policy issues that, effectively, extended the efficient market approach to the entire economy".

Among the portrayed reality-based heroes are Pique "Spill-over effects", Bators, "Market failures", Akerlof, "Hidden information", Arrow, "Moral hazard", and Minsky, whose thoughts on leverage creates the "Moment". Keynes really returns with his derivative thoughts on the "Beauty Contest".

This book has been elected "The Economist book of the year" and "A Businessweek best book of the year". I understand fully why. This overview of the evolution of economic theory is unmatched with anything I have read so far. And the last part, The Great Crunch, is almost up to par with the two first which is impressive.

Michael Persson, August 23, 2012