



Works in Theory

Flash! Economics is an art, not a science.

BY IRWIN M. STELZER

The authors' claim is nothing if not immodest: "We accomplish what existing economic theory has not. We produce a theory that explains fully and naturally how the U.S. economy, and indeed the world economy, has fallen into the current crisis." This is to be accomplished by proving—no, arguing—that man does not live by bread alone, or do calculus before making every decision.

Fair warning: The reader will be lucky to avoid being singed from the flames of burning straw men. Consider the attack on "those [unnamed] who think that the economy should just be a free-for-all," populated by consumers and investors whose irrationality might create massive macro-economic swings. Or on "economists [also unnamed] and business writers ... [who] assume that variations in individual feelings, impressions, and passions do not matter." Or on those (again, unnamed) who believe that "free market capitalism will be essentially perfect and stable." Irrationality among private-sector actors, of course, requires an increasingly active set of rational government regulators and other public-sector players to contain the boom-and-bust cycles produced by these private passions.

Liberals who are so keen on warning labels will agree that this book should come with a large-print warn-

ing: Beware the bias against private-sector actors who might get in the way of the increased government that accounting for irrational human behavior necessarily requires.

Three examples should suffice:

First, in discussing the savings and loan scandals, the authors argue that failed S&Ls were "worth a great deal for whatever sweetheart deals their owners could make." The evils of the S&L deals were that they presented the opportunity of "kickbacks from developers, or they could involve the purchase of risky but high-paying assets."

Kickbacks are illegal if concealed; purchasing risky assets in the hope of profit is one of the perfectly legal acts that make markets work.

This grouping of the illegal with legal risk-taking morphs into an attack on Michael Milken who, in fact, did more to shake up the "fat cats" that are now so hated than all of the government regulators and shareholder activists combined—a fact that eludes the authors.

Second, it seems that "the bounty of capitalism has at least one downside. It does not produce what people *really* need; it produces what they *think* they need, and are willing to pay for." (The emphasis on "really" is mine.) Shades of John Kenneth Galbraith and others who worried about the manipulative powers of the madmen on Madison Avenue. How the authors are able to decide what people "really" need is not made clear, but it should worry policy makers that these two gentlemen, given the opportunity to decide, will decide what people only "think" they need,

and confine their purchases to only those things they "really" need.

Advocates of more government often persuade themselves that they are capable of such decisions, and that advertisers are so skilled that they can persuade consumers to buy lots of stuff, repeatedly, that they only think they need. Dangerous, that.

Third, the authors are appalled at the level of executive compensation. But instead of attacking the flawed process by which compensation has been set—a process only partially corrected by Sarbanes-Oxley's requirement that directors be independent of the CEOs whose compensation they are setting—they proceed to attack the Milken-led takeover wave that wiped out a great deal of the cause of the problem: the separation of ownership from control, and the cozy relationship of executives and their boards.

The authors complain that when firms were taken private, using junk bonds (less pejoratively known as high-yielding debt instruments), executives profited massively. Note the sly construction of this sentence: "If the firms that had been taken private could pay off the junk bonds, these executives would be rewarded enormously." It is not "the firms" that paid off the bonds, it is the executives who were "rewarded enormously" that did so. The process was one in which the separation of ownership and control—complained about over 75 years ago by Adolph Berle and Gardiner Means in their classic, *The Modern Corporation and Private Property*, for producing a principal-agent problem—was corrected, and the incentives of owners and managers aligned properly.

By eliminating corporate jets, corporate wine cellars that in one case numbered 20,000 bottles, and pay that bore no relation to performance, what the authors describe as "Milken's exploits" did a great deal to increase the efficiency of the firms that fell into their hands—and to break the monopoly of the interlocked financial establishment on credit. To argue, as the authors do, that "it *could be* that the timing of the new inequality were merely coincidental" (emphasis added) and that this

Animal Spirits
How Human Psychology Drives the Economy and Why It Matters for Global Capitalism
by George A. Akerlof and Robert J. Shiller
Princeton, 264 pp., \$24.95

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new inequality “does highlight the fragility of capitalism” is to leap from the erroneous to the absurd.

But these are quibbles compared with my main problem with this book: Its misrepresentation of Keynes’s view of the role of “animal spirits” and its failure to concede that economists have long recognized that man is not a two-legged computer.

Start with John Maynard Keynes. As the authors note, he pointed out in *The General Theory of Employment, Interest and Money* that “our decisions to do something positive . . . can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” But the great man is careful to point out that animal spirits are not the whole of the story: “Reasonable calculation is supplemented and supported by animal spirits . . . [and] we should not conclude from this that everything depends on waves of irrational hysteria.”

In short, “whim or sentiment or chance” plays a role in the affairs of men, but calculation and reason also matter. More important, the conclusion the authors draw from their emphasis on irrational behavior is this: “Without intervention by the government the economy will suffer massive swings in employment.”

Well, yes. But there is intervention and there is intervention. There is intervention in the form of monetary policy, the effectiveness of which Keynes had serious doubts about, and fiscal policy, as to the effectiveness of which many conservatives remain unpersuaded. There is intervention in the form of regulations that force transparency and encourage information symmetry, and that align the interests of society and individual actors (requiring skin in the game for mortgage lenders is one such) and locks up fraudsters.

Then there is intervention of the sort that Keynes warned against, a warning that the current administration might usefully consider. “Economic prosperity,” he wrote, “is excessively dependent on a political and social atmosphere

which is congenial to the average businessman.” Surely that “atmosphere” is poisoned by populist attacks, and by some of the features of the policies now being proposed, including pervasive regulation of financial institutions by risk-averse government employees.

In sum, I wonder what this beautifully written book has to tell us. Economists have always known that real people don’t behave like the completely rational folks of their theories, and good economists do their best to adjust their conclusions to incorporate that fact. We have also known that fairness, which the authors accuse economists of neglecting, often trumps efficiency. It is the job of economists to tell politicians the cost of their various quests for fairness, and for politicians to decide if the cost is worth bearing.

And we have long known that the government has to set the rules of engagement for combatants in the

marketplace, and that those rules need revision to catch up with the innovations in financial markets. Of course, in this current crisis we have seen the government become a player in the game, as well as its referee—and we don’t yet have a strategy to restore control of the allocation of capital to a properly regulated private sector.

The authors would have been well advised to tone down their claim for novelty and importance: “We accomplish what existing economic theory has not.” Not so. Better, perhaps, to have made the more modest suggestion that those model-builders who brought so many financial institutions to ruin in recent years might have done less damage if they had given a bit of thought to some of the points made by the authors: They are right that there are more things going on in markets than are dreamt of by model builders.

Not news to most economists. ♦



‘Truth and Metre’

A poet in touch with his critical faculties.

BY EDWARD SHORT

In 1891, Henry James reaffirmed his respect for criticism by stressing what he might have called its exiguity:

The critical sense is so far from frequent that it is absolutely rare, and the possession of the cluster of qualities that minister to it is one of the highest distinctions. It is a gift inestimably precious and beautiful; therefore, so far from thinking that it passes overmuch from hand to hand, one knows that one has only to stand by the

counter an hour to see that business is done with baser coin. We have too

many schoolmasters; yet not only do I not question in literature the high utility of criticism, but I should be tempted to say that the part it plays may be the supremely beneficent one when it proceeds from deep sources, from the efficient combination of experience and perception. In this light one sees the critic as the real helper of the artist, a torch-bearing outrider, the interpreter, the brother.

**Collected
Critical Writings**
by Geoffrey Hill
edited by Kenneth Haynes
Oxford, 832 pp., \$49.95

Into this exclusive club James would certainly have admitted the French critics who influenced

him—Sainte-Beuve, Taine, Gautier, Daudet—but I suspect that he had English and American critics in mind when he spoke of his age having “too many schoolmasters.” We are plagued with the same surplus, though our schoolmasters

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