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Books in Brief

by David K. Hurst

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Meltdowns past and present, confused credit markets, irrational individuals, and the seedy business of infomercials.

by David K. Hurst

The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession
By Richard C. Koo
Wiley, 2008, 312 pages

The field of macroeconomics was born during the Great Depression, in an effort to explain why the world did not behave in the way that classical economics (what we would today call microeconomics) predicted — as a system that would correct itself over time. Its first practitioners followed the lead of John Maynard Keynes, who held that the problem was insufficient consumer spending and that governments could fight back with deficit spending (I am oversimplifying a bit). By the 1970s, the pendulum of economic fashion had swung widely to monetarism, which held that the problem was overly timid central banks, which could defeat downturns with aggressive interest-rate cuts and money creation.

Since then, policymakers have tended to borrow elements from both schools and oscillations have been smaller, in theory because — at least until 2008 — the economic challenges have been less severe and have been localized, rather than

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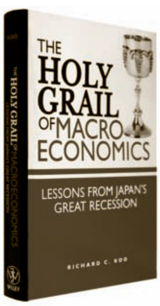
(david@davidkhurst.com) is a contributing editor of *strategy+business*. His writing has also appeared in the *Harvard Business Review*, the *Financial Times*, and other leading business publications. Hurst is the author of *Crisis & Renewal: Meeting the Challenge of Organizational Change* (Harvard Business School Press, 2002).

global. But the Great Depression has never been fully explained. Indeed, in 1995 the current chairman of the Federal Reserve, Ben Bernanke (then a professor at Princeton University), wrote that "to understand the Great Depression is the Holy Grail of macroeconomics."

Now the global, systemic economic crisis has set the pendulum of economic theory swinging wildly again, as we try to understand what has happened and why. As we look to the past for clues to the present and the future, the quest for the Grail has been renewed. Enter Richard C. Koo, chief economist of the Nomura Research Institute, the research arm of Nomura Securities. In *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession,* he uses his study of Japan's long slump from 1992 to 2007 to argue that that period, the Great Depression, and our present predicament are all examples of what he calls "balance-sheet recessions." These happen in the aftermath of the bursting of an asset bubble, when the private sector has a negative net worth and is more concerned with paying down debt than with lending or spending. Under these conditions, monetary tools are useless because firms and individuals refuse to borrow, even when interest rates go to zero. The only solution is for government to step in and boost demand until balance sheets are rebuilt and banks and individuals are ready to lend and spend again. Thus Koo arrives at the same prescription as Keynes, although he travels by a different route.



Koo documents his conclusions exhaustively with evidence from the Japanese recession and the Great Depression. His Taoist perspective on system dynamics highlights two distinctly different phases of a business cycle. First there is the *yang* phase of healthy balance sheets and profit-maximizing firms in which monetary policy works and the best government is small and non-intrusive. But if it is allowed to continue for too long, a *yang* cycle, via the collapse of asset prices, may turn into a *yin* cycle, in which firms and individuals are preoccupied with paying down debt, which renders monetary policy ineffective. In this phase, tax cuts may be fruitless for the same reasons — individuals and firms will use the windfall to pay down debt rather than to spend. In our current quandary, the *yang* phase sounds suspiciously like a Republican view of how the economy works, whereas its *yin* complement is closer to the Democratic perspective. From a Taoist point of view, both are right and both are wrong, but at different times.

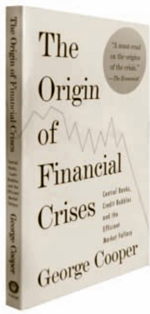
In 1967, economist (and subsequent Nobel laureate) Kenneth Arrow identified three "scandals" in macroeconomic theory: its inability to integrate microeconomics, its failure to incorporate imperfect competition (the fact that competition is often limited by restrictive practices), and its failure to incorporate transaction costs (the fact that costs are incurred in making economic exchanges). Little progress has been made on these issues in the ensuing 40-plus years. Koo clearly believes that his framework can form the basis for a new synthesis and general theory that resolves these scandals.

The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy
By George Cooper
Vintage Books, 2008, 204 pages

British financial market analyst George Cooper takes aim at one of the central tenets of classical economics — the belief that financial markets, like the economy as a whole, behave rationally and move toward equilibrium over time (the "invisible hand" of Adam Smith's famous metaphor). In *The Origin of Financial Crises: Central Banks, Credit Bubbles and the Efficient Market Fallacy,* Cooper makes an eloquent argument that there is little evidence of this phenomenon in

Central banks are customarily run by economists who often don’t believe in the necessity of their role in the first place.

credit markets. Indeed, the evidence is that these markets are inherently unstable, and that the markets, far from being able to handle disruptions, tend to amplify them.



This difference between what should happen in theory and what does happen in practice, as the author shows, is reflected in the widely divergent philosophies and mandates of central banks. Most conventional economic theory claims that markets are efficient and should be left alone, but experience suggests that crises are inherent in the system and central authorities are needed to regulate and control it. To compound this confusion, central banks have conflicting practical mandates — to restrain credit and money creation for financial stability and inflation control, and to promote it for economic growth and to avoid economic contractions. Capping it all off, central banks are customarily run by economists who often don’t believe in the necessity of their role in the first place. Talk about confused!

Cooper turns for guidance to Minsky, Mandelbrot, and Maxwell. The late American economist Hyman P. Minsky developed his “financial instability hypothesis” in the 1960s, suggesting that self-reinforcing expansions could flip into self-reinforcing contractions in what have come to be called “Minsky moments,” but his work was largely ignored. Benoit Mandelbrot, the French mathematician best known as the founder of fractal geometry in the 1970s, has long argued that transactions in financial markets are not independent, as required by the efficient markets hypothesis, but exhibit a form of “memory.” James Clerk Maxwell — the Scottish mathematician and physicist — pioneered the scientific study of control system engineering in the 19th century. All three men, the author contends, have something to teach us about the behavior of financial markets. Minsky and Mandelbrot help us understand why financial markets are inherently unstable, and Maxwell shows us how to control them.

The essence of control of any complex system is patience and a light touch, a combination that allows the system to settle down over a period of time. Impatience and efforts to impose heavy controls introduce further disturbances into the system and may send it careening out of control. Unfortunately, the margins between the light and heavy approaches are narrow and they may move over time, creating the potential for central bankers to be disruptive rather than calming presences. Cooper suggests that a lot must change if we are to manage financial markets effectively, both in the way that economists and finance theorists measure the probabilities of extreme market events, and in the operating procedures of central bankers. The clarity and vigor with which the author makes his arguments compel our attention.

Free Market Madness: Why Human Nature Is at Odds with Economics — and Why It Matters
By Peter A. Ubel
Harvard Business Press, 2009,
272 pages

Peter A. Ubel, a physician, behavioral scientist, and professor of medicine and psychology at the University of Michigan, challenges an even more basic assumption of classical economics — that people

Infomercials appeal to people's classic needs using the familiar promises of looking better, having more money, and saving time.

behave rationally in economic matters. In *Free Market Madness: Why Human Nature Is at Odds with Economics — and Why It Matters,* he argues specifically with the libertarian, free market evangelists who tout the unregulated marketplace as the solution to all ills. His book is an accessible guide to the evidence that people do not behave as microeconomists would like them to, and to the implications of this for public policy. Ubel sums up his central message as follows: "We humans are not as rational as some libertarians would have us believe, and therefore the free market puts us in a position to harm ourselves. To make matters worse, the free market often rewards those people who understand consumer behavior well enough to exploit our weaknesses. Because the free market fails to protect consumer interests, a good government should find appropriate ways to protect us from ourselves."

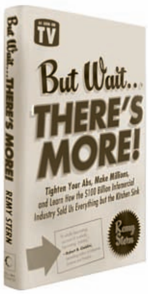
These are fighting words to those who fear the rise of a "nanny state" that undermines the exercise of free will and the acceptance of personal responsibility. But the author goes about his task calmly as a self-described "flaming moderate." He shows us evidence that our stocks of self-control are finite. This is readily apparent in our eating habits, where the stress of everyday living and working can erode our intentions to eat healthily. This may account for the fact that obesity rates are 25 percent higher among low-income women than they are among high earners of the same age, and are rising fastest in some of the poorest areas in the world.

The work of Nobel Prize winners Daniel Kahneman and the late Amos Tversky, the founders of behavioral economics, is referenced throughout the book. We learn, too, of the views of their intellectual predecessors, such as Jeremy Bentham and David Hume, as well as their successors, such as University of Chicago professor Richard Thaler and his colleague and coauthor Cass Sunstein, who was named as President Barack Obama's administrator of the White House Office of Information and Regulatory Affairs. Ubel's academic perspectives are leavened throughout the book with stories from his experiences as a physician, through which he has firsthand encounters with smokers who can't quit and overweight people who can't diet. It is this combination of the theoretical and the practical, along with the author's ability to move smoothly between the two, that gives the book its charm.

But Wait...There's More! Tighten Your Abs, Make Millions, and Learn How the $100 Billion Infomercial Industry Sold Us Everything but the Kitchen Sink
By Remy Stern
Collins Business, 2009, 272 pages

Remy Stern, the editor and publisher of the New York–based society-tracking Web site www.Cityfile.com, provides a fascinating look into one industry that thrives by exploiting the weaknesses that behavioral economics reveals. His new book, *But Wait…There's More! Tighten Your Abs, Make Millions, and Learn How the $100 Billion Infomercial Industry Sold Us Everything but the Kitchen Sink,* is a highly readable, gossipy history and exposé of the industry. It is a window on entrepreneurial capitalism at its most raw — a no-holds-barred world of largely unregulated activity.

The infomercial industry has its origins in the country fairs of centuries past, where hucksters and snake-oil salesmen plied their trade freely. The first radio infomercials began in the 1920s, but nothing facilitated product demonstrations and the use of a full range of persuasive techniques like television. Pitchmen soon discovered that their audience's resistance was lower late at night, and with the advent of toll-free telephone numbers, credit cards, and the deregulation of cable TV, the modern era of the infomercial was born.



Infomercials appeal to people's classic needs — emotional well-being, self-image, and relationships — using the familiar promises of looking better, having more money, and saving time. Marketers bring every psychological pressure to bear, including the use of testimonials from satisfied users, attractive presenters, and celebrity pitchmen. This dubious art is raised to an exact science on the home shopping channels, such as QVC (a U.S. company also operating in the U.K., Japan, and Germany), whose operations the author explores in some detail. The format gives promoters immediate feedback on which products and selling techniques are working and which are not. One time-tested tactic is to build a trusting relationship with viewers using bogus narratives about the product and its origins. Thus frozen crab cakes are represented not as the product of a multinational conglomerate but as the creation of a third-generation fisherman from Maine who is using his grandmother's recipe.

But Wait…There's More! shows how government regulation of the industry has been thoroughly compromised in the United States. At the policy level, the Federal Communications Commission has become deferential to the networks it is supposed to govern, and neither they nor their local stations are required to take any responsibility for the integrity of their products. At the transaction level, the Federal Trade Commission is perennially understaffed and under-resourced, and can impose only small fines when it catches bad actors. For the crooks, such fines have become just another cost of doing business. Interestingly, the author argues that the same advances in technology that brought the industry into being may help to reform it. The advent of Web sites such as www.infomercialscams.com, for example, allows for genuine feedback on the merits of many products and services. But be careful not to type a double *s* in the middle of that URL or you could end up with the bad guys! ✚

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