



Letter to the Editor On the Wikileaks of the Economics Profession

May 31, 2011

The following is in response to Michael Edesess' article, [The WikiLeaks of the Economics Profession](#), which appeared last week. That article was a review of the book, What Caused the Financial Crisis.

Dear Editor,

While I found Michael Edesess' review interesting and generally helpful, I can't help but be curious about his stark skepticism that the demand side (institutional and retail investors) of a market would be able to recognize its own urges and needs and insist that the supply side of the market respond in some way. Edesess paints a picture of a hopeless and hapless demand side bumbling along as a mere innocent victim of whatever the eternally scheming, ill-intentioned suppliers want to thrust upon them.

To wit: Edesess seems fully onboard with Richard Posner's perfunctory and dismissive attitude, in his afterword to the book Edesess reviews, toward the idea that the big rating agencies' failure to provide quality analytic products was a natural byproduct of their irrational government-manufactured oligopoly status that shielded them from market forces and discipline that otherwise might have informed their work. Edesess says, in effect, that even without the oligopoly, there would be no natural demand anyway for rigorous rating firms that would be perceived as a wet blanket. Really, and we know that how?

A scant few paragraphs later, in conclusion, Edesess again rails about how financial service institutions routinely misled, abused and grossly under-informed the pitiful, helpless buyers of their products and services.

While Akerloff's Nobel-winning Lemon Theory beautifully describes the asymmetry of information between buyers and sellers, it doesn't suggest that the demand side of a market is made up of little more than a collection of hapless fools who would simply perish without a regulatory morass descending from the heavens to save them. To the contrary, those hapless fools on the demand side have been reasonably successful in dealing with used-car salesmen, both literal and metaphorical, for years.

My takeaway from the essay collection was that when society deems it necessary to call in a white horse-mounted savior in the form of government regulation to save us from ourselves, we had best be aware of the unintended consequences of the increasingly tangled, unnatural, volatile and even dangerous web we are weaving.

I'm glad to see you bringing attention to what I consider to be this very informative work.



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Michael Edesess responds:

I am grateful for Cumbie's comments, because they go to the heart of a debate we need to have, a debate for which the financial crisis provides ample fodder.

Milton Friedman thought that markets didn't need regulators because buyers would keep sellers honest by refusing to buy their products if they were not good.

This, of course, ignores the fact that buyers need to have dependable information in order to evaluate whether the products are good or not. It makes the assumption that economists always made and have now – in the wake of the crisis – become infamous for making: that economic agents have perfect information.

It's simply not possible for most individuals to evaluate each and every product that comes along, so people put their trust in reviews and endorsements. When the endorsements come from the sellers themselves, it's a matter of trusting their "brand." There reasons not to trust information about a product provided by the seller (or even intermediaries who are to one degree or another "in bed" with the sellers) are obvious; but people have become accustomed to being insufficiently skeptical about such information, perhaps because they don't know what other source is more reliable. The incessant dismissal of the positive role government can play doesn't help.

I submit that government agencies that are reasonably well insulated from outside pressures can be reliable sources of information – even though they may not always live up to that role. When I want accurate and unbiased information about a financial product, I often find that the U.S. Securities and Exchange Commission's website is a good source. It's certainly more reliable in transmitting the whole truth than the websites of most product providers.

We need more of this, not less.

I'm baffled by the claim of Wallison, Jeffrey Friedman, and Cumbie that the oligopoly status awarded to a select few ratings agencies "shielded them from real market forces," that otherwise would have somehow caused them to produce more accurate ratings. Airlines have a kind of oligopoly status too, but whenever there are two airlines plying the same route, market competition mercilessly drives their profit margins down. In this case, however, the customers are passengers. What if instead the airlines were paid by aircraft



manufacturers and maintenance operators to provide passengers with ratings of the aircraft? Market forces would behave in an entirely different – and I think unsettling – manner, and this is a much better analogy for the situation of the rating agencies. I don't see how it would matter that the airlines have an oligopoly; it would be the structure of their market and payments that could cause a dangerous problem. In this case, passengers would have to rely – as in fact they do now – on government agencies to keep flying safe.

I agree with Cumbie that it should not be necessary “to call in a white horse-mounted savior in the form of government regulation to save us from ourselves,” if the assumption is that even given the best information we don't know what's good for ourselves, but government does. I do think, however, that there can be a role for government in providing accurate and unbiased information – sometimes even in direct hand-to-hand combat with corporate interests. Then-Surgeon General C. Everett Koop's drive in the 1980s to neutralize the tobacco companies' campaign of misinformation is a good example. I think we need a C. Everett Koop for the financial industry, because its habit of misleading buyers as to the benefits and costs of financial products is endemic to the industry and has reached epidemic proportions. I don't mean, of course, to paint all the industry's participants with the same brush – there are many truly honest and helpful providers. But they are working against the tide.

Michael Edesess

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