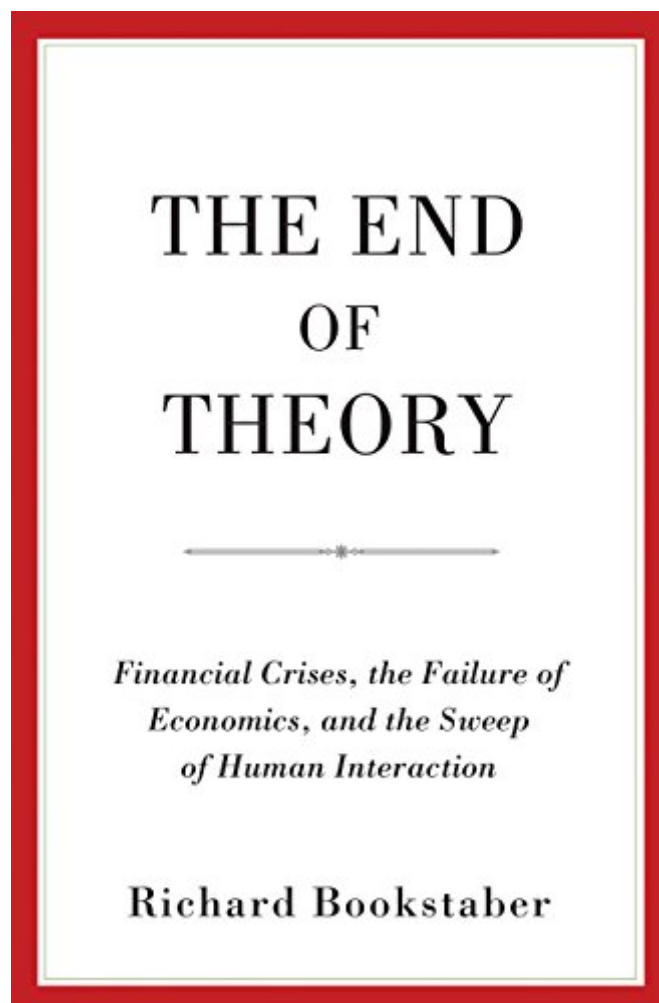




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The End Of Theory: Financial Crises, The Failure Of Economics, And The Sweep Of Human Interaction



Synopsis

An in-depth look at how to account for the human complexities at the heart of today's financial system. Our economy may have recovered from the Great Recession—but not our economics. In *The End of Theory*, Richard Bookstaber discusses why the human condition and the radical uncertainty of our world renders the standard economic model—and the theory behind it—useless for dealing with financial crises. What model should replace it? None. At least not any version we've been using for the past two hundred years. Instead, Bookstaber argues for a new approach called agent-based economics, one that takes as a starting point the fact that we are humans, not the optimizing automatons that standard economics assumes we are. Bookstaber's groundbreaking paradigm promises to do a far better job at preventing crises and managing those that break out. As he explains, our varied memories and imaginations color our economic behavior in unexpected hues. Agent-based modeling embraces these nuances by avoiding the mechanistic, unrealistic structure of our current economic approach. Bookstaber tackles issues such as radical uncertainty, when circumstances take place beyond our anticipation, and emergence, when innocent, everyday interactions combine to create sudden chaos. Starting with the realization that future crises cannot be predicted by the past, he proposes an approach that recognizes the human narrative while addressing market realities. Sweeping aside the historic failure of twentieth-century economics, *The End of Theory* offers a novel and innovative perspective, along with a more realistic and human framework, to help prevent today's financial system from blowing up again.

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Customer Reviews

This book fills an essential niche between highly theoretical work on complex systems and the day-to-day risk management practiced in financial institutions. The author offers a sophisticated treatment of agent-based modeling using simple concepts and no mathematics. The work is deeply informed by a long career on the front lines of risk management, both in top global financial institutions and as a regulator. This distinguishes it from more abstract treatments or direct importation of concepts from physics. Agent-based modeling leads into a discussion of emergent phenomena, macro level effects that are not the intention or forecast of any individual agent. Here too the phenomena are strictly relevant to finance, both from observation of past crises and reasoning about potential future ones. Another feature of agent-based modeling is non-ergodicity, and fancy way of saying that sometimes the dice change in between rolls. Finance and other human interactions do not display the mild randomness of the casino, where all outcomes and probabilities are known in advance, and in the long run the house wins its expected amount. The author stresses that we cannot predict future crises from past ones, because we have no idea what will spark the next disaster. Personally, I would emphasize that people will react differently to the next spark because of what happened the last time--while there are an infinite number of bad things that can happen, there's a fairly small number of ways they usually work out. For example, we know that financial disasters are usually accompanied by credit contractions. You don't need to guess what's going to cause the next crisis to make sure you're prepared for credit disappearing. But this is a point of detail, I certainly agree that preparing for the last crisis is a poor approach to risk management. The result of all this is radical uncertainty. The only way to predict the future is to live it. The author claims there are no mathematical or analytic shortcuts. Here I think he overstates the case a little. There are top-down, equilibrium forces that have strong influences on events. They do not seem important at the height of the crisis, but they do matter. During a hurricane, it's foolish to say that air pressure has to equalize so there's no need to worry about the wind. But it's not foolish to reason from simple physics that it takes energy to maintain differences in air pressure, and so the hurricane will eventually run down. While reading this book, I was reminded of Tetsuo Takashima's

novel *The Tsunami*. Written six years before the 2011 Tōhoku earthquake, it posited a larger-than-forecast tsunami inundating a nuclear power plant. The hero quits his promising academic career predicting earthquakes to take a low level municipal job in disaster preparedness, and spends his time developing a simple computer application to link up local officials. He runs scenarios from the bottom up, not to guess when or where a tsunami will hit, but to react appropriately after one does. The tsunami predictions are worse than useless. After a shock, all transport and nuclear plants are shut down. Since it's summer and work is canceled and there's limited air conditioning, after a few days of no disaster, people all go to the beach, just in time for the big wave. Unless you can predict with high confidence well ahead of time, you do more harm than good. But bottom-up preparedness based on running many simulations with the people who know local conditions and will be making decisions in the crisis, do tremendous good, whenever the disaster strikes and whatever specific form it takes. The author keeps the book interesting for non-specialists by not getting into the technical details of how risk managers attempt to do these things. We're more likely to say we're doing "scenario analysis" than agent-based modeling, but it's the same idea, if a bit less fancy. You work out as many macro scenarios as you can think of, based on the past and speculation about the future, and try to guess how every important actor will behave. Since you never know that for sure, you run lots of simulations with random deviations. This is no help for predicting the future, you know it will not resemble any of your simulations. But there is actually a manageable number of key decisions: where to set limits, how much cash to hold, when to cut losses and so forth. If these are set in a manner to avoid disaster in as many scenarios as possible, you have some hope that the discipline of preparing for what you can foresee gives you the flexibility to survive whatever happens. Risk managers call non-ergodicity "regime shifts" and build them into models. Emergent phenomena are nice to think about, but have not found their way into risk management practice. The issue is that there is a cost to precautions. You need to make enough money in good times to make it worth surviving the bad times--and profits build capital and create equity value that can separate survivors from road kill in a crisis. There are enough known phenomena to prepare for, and the kind of preparations are generally useful for most unexpected phenomena as well. In most cases there isn't attention and other resources to spare for specific preparations for plausible phenomena predicted by agent-based models that has never been observed; especially because we cannot imagine them in sufficient detail to design many specific preparations. Radical uncertainty is used more in a negative way than a positive one. All model-based predictions--pricing models and risk models--are matched by a "and if the model's wrong. . ." contingency plan. The answer is not a backup model, but a checklist for how to survive

when you don't trust models. The only major disagreement I have with the book is I think the author oversells how much good this does. Great risk management does not eliminate crises or make them easy. At best, it gives a little extra edge. In the long run, we hope that extra edge makes a difference, but (radical uncertainty) you won't know that until afterwards, if then. In fact, it is the idea that experts should be able to predict and prevent disaster that leads to people over-reacting to each crisis. People's expectations are so high, that their judgment of actual performance is so low, that they try to fix too much. This is the best available book that bridges the gap between academic theory of complex systems and practical financial risk management.

Half way through the book and it is very well written. The first half lays out some theoretical framework and definitions such as emergent phenomena and radical uncertainty. There is a little overview of Soros' reflexivity theory as well, which I found very interesting given the current bubbles in cryptocurrency. This book is addictive and can't wait to dive into the second half. Will update this review once completed.

I like the ideas of how the 150 years old theory failed to predict financial crisis. The beginning of the book is really enjoyable getting tougher with logic and financial terms in the middle. Readers who know something about finance will get the most benefit from the book, especially academicians. In the end, this book content quite inspiring to give different view how agent behavior and the nature of crisis lead to financial disaster.

Brilliant book. Excellent follow up to A Demon of Our Own Design.

This is an important book on a critical subject. Every few years, we stumble through a financial crisis followed by post mortems that usually end up with folks throwing up their hands and asking "who could have known?" Crucially, standard economic models are not designed to gracefully explain crises whereas the agent-based models Bookstaber describes are intended to do exactly that. Part history, part philosophy and part polemic, "The End of Theory" is a great introduction to a new way of thinking about financial crises. To those who claim there is nothing new here, I recommend a more careful reading of the book. Clearly, some will react defensively to the criticism of neoclassical economics but it is important to keep the broader picture in mind. It is difficult to model future financial crises using historical data and standard methods. Bookstaber provides a way forward that is well worth considering and certainly worth debating.

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